TIFF INSIGHTS

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THOUGHT LEADERSHIP

CIO Quarterly Commentary

4Q2021

What Will Matter Most in 2022

Anticipating the most impactful events of each coming year is a Wall Street tradition, and one we can hardly pass up either. Every year significant things happen in the world that meaningfully impact the markets, and hence, your portfolio, whether or not you choose to specifically address these potential disruptions. For example, some believe that 2022 could see China invade Taiwan or Russia start a pan-European war. We do not expect either scenario (although Russia may indeed invade Ukraine) and so we are not currently positioning our portfolio for either possibility. Even though we are "doing nothing" about these issues, we would call that an important decision in and of itself. We are aware of the potential scenarios, but do not share a belief in their likelihood. Others will take different views and may position their portfolios either to avoid what they believe will be bad outcomes, or even attempt to benefit from such outcomes. Those who have positioned to avoid bad outcomes sometimes enable markets to end up rallying on, for example, "bad" economic numbers that are actually "less bad" than they expected, and vice versa. Ultimately, the market is a forward-looking discounting machine.

Significant issues that arise unexpectedly, often referred to as "black swans", can dramatically impact portfolios because, by definition, nobody has positioned for a black swan. In 2020 no living investor had experienced a global pandemic. No one had a sense of how many people might be infected, might survive or die, how society would behave, or what governments might do. These uncertainties caused markets to drop precipitously in a short period of time. Nobody anticipated a global pandemic, and nobody was positioned for its arrival. History has shown that when a significant disruption occurs, after a period of chaos during which some investors reshape their portfolios dramatically to include new risks while others take little to no action, the markets rediscover an equilibrium and again begin to discount the future. If, after the initial shock and repositioning period, events subsequently evolve in a more favorable way than had been discounted, then markets will likely rise, and vice versa. We saw this in 2020 and 2021. Millions of people lost their jobs and their lives, but, frankly, not as many as originally feared. With great help from governments a global depression was prevented, and jobs returned much faster than anyone could have imagined, which led to a stronger economy and persistent market advances.

As we anticipate the most impactful events of this coming year, we acknowledge that there are many potential items we may leave off the list either because we don't think they will occur or because they are not being considered by us or the vast majority of investors. Nonetheless, we will highlight some of the important items we think the market is broadly attempting to discount. Like everyone, if another black swan arrives, we will navigate the environment as best we can based upon our experience, our collective common sense, and the insight and input from our board and the managers with whom we partner. Here's to a much less exciting 2022.

We think the important calls next year are:

1. Will inflation prove largely transitory and what will the Fed do?
2. Can stocks continue to move higher?
    a. Will US stocks continue to outperform the rest of the world?
    b. Will growth stocks outperform again?
3. Will China remain weak and underperform?
4. Will COVID continue to impact our daily lives or truly and finally begin to fade?

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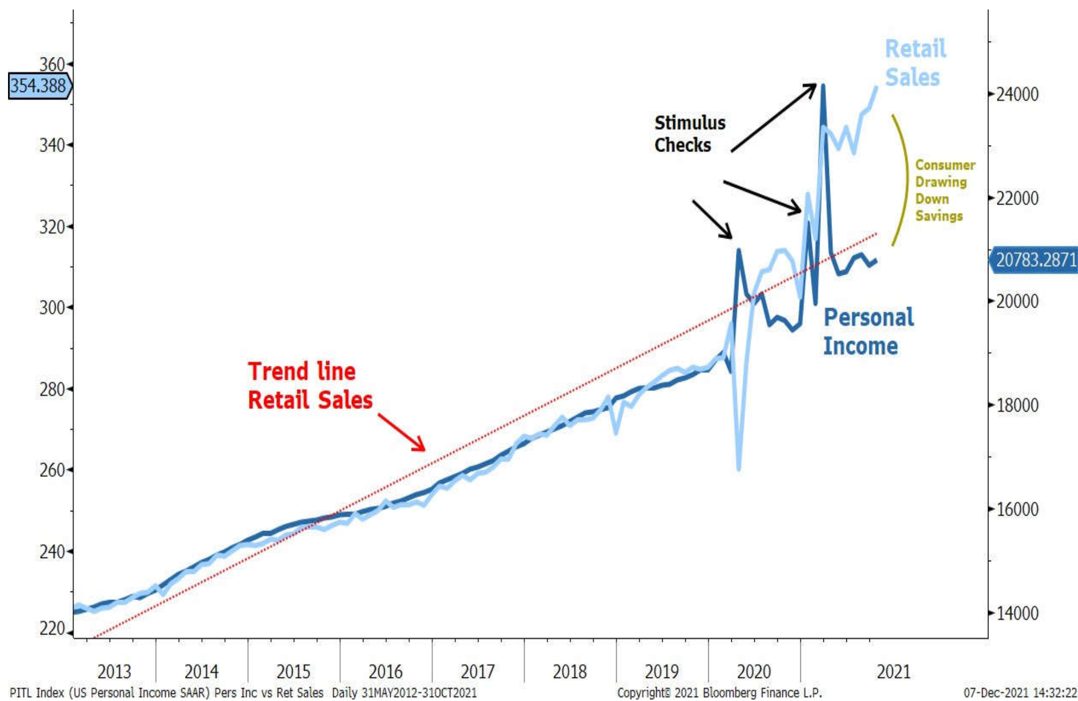
Assuredly, other issues both large and small will impact markets in the coming year, but we hope this list includes most of the significant issues we will face.

Inflation and the Fed

We've written about it a lot already so won't belabor the point, but inflation is still the number one issue that investors will confront in 2022. Is it transitory or is it going to become ingrained? We continue to believe it will be "transitory", although just recently Fed Chair Powell eliminated the term from current discussions and acknowledged that "Supply and demand imbalances related to the pandemic and the reopening of the economy have continued to contribute to elevated levels of inflation."[1] Not to sound like a sore loser, but that does not change our expectation that by this time next year, the Consumer Price Index (CPI) will print numbers <3%. Adding a little further insult to our view, the dot plot of the Fed now suggests three rate hikes next year, up from about one-half of one rate hike. Two facts bolster our confidence. First, the fact that three items (owners' equivalent rent, fuels, and new and used car prices) accounted for 4.2% of the latest CPI print of 6.8%, and second, the apparent end of the Build Back Better plan by Joe Manchin. Moderating economic growth suggests to us that it will be hard for prices to increase next year as much as they have this year.

The following chart shows income vs spending going back to 2013. It suggests that the supply chain shortages may in fact be demand bulges. If that is the case, then the question becomes: "are they sustainable?" This chart should at least raise some doubt. Most economists estimate there is as much as $2 trillion of remaining excess savings, but it is being spent.

The Good News: Consumer Has Savings to Tap Into—Will it Continue?



Source: Bloomberg, Morgan Stanley & Co. Research as of December 7, 2021

Away from the internals of the numbers, the market is also forecasting lower inflation ahead. We have pointed this out before and share these charts so you can see for yourself.

[1] December 15, 2021, Federal Reserve Board - Federal Reserve issues FOMC statement

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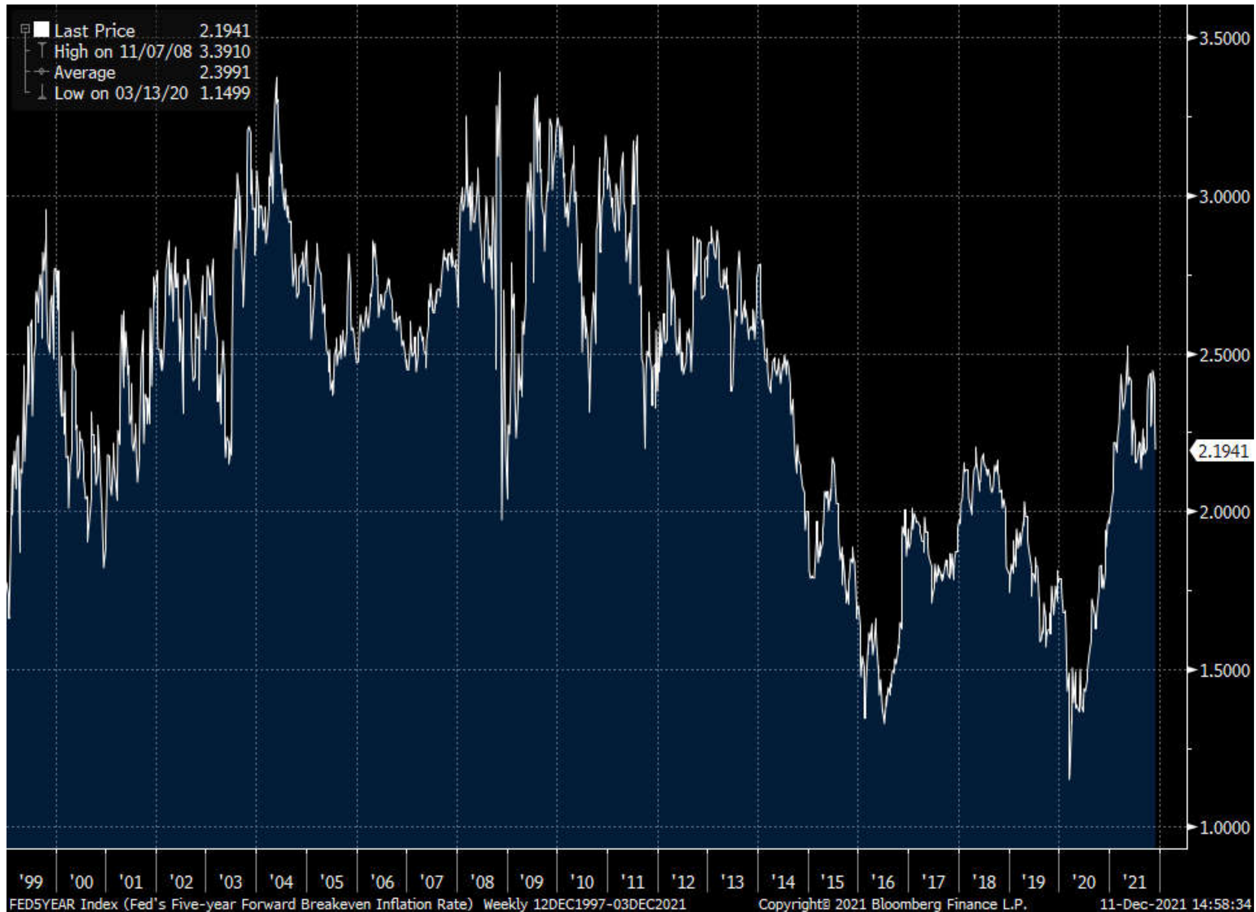

Source: Bloomberg

The most recent Fed 5-year forward inflation rate is 2.19%, less than the average of the last 20 years and lower than earlier this year.

The next chart shows the going-in real rate investors earn on today's 10-year treasury. This -5.36% real yield is the lowest on record. It's even lower than in 1974 and 1980 during the oil embargoes that created the only two real inflation episodes in the modern Federal Reserve banking era. This real rate will, of course, change as inflation in the future rises or falls, but the nominal yield of 1.48% will not. For an investor today to earn a positive real yield, inflation needs to drop below 1.48%, and fast. If you lose 5% real per year for the first 5 years of your investment it is almost impossible to make that back in the second 5 years. We still do not believe a rational investor would purchase treasury securities at today's prices unless she was fairly confident that inflation rates would soon be falling back to the Fed's 2% target or lower. The following chart makes it obvious why we keep saying we think fixed income is a bad investment today. Maybe rates will rise or maybe inflation will fall, either way we think there are better places to invest.

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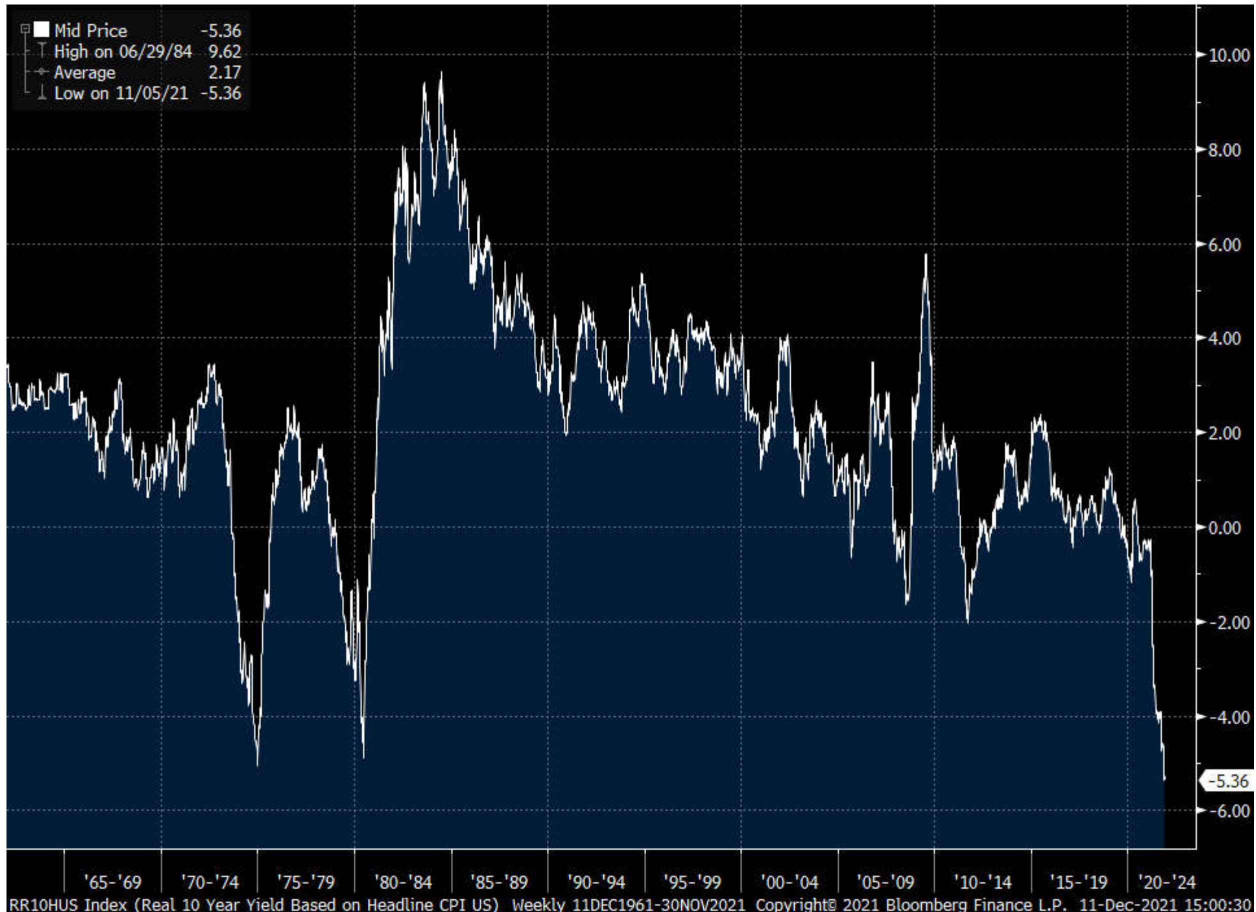

Source: Bloomberg

We summarized very briefly what the Fed did a few paragraphs back. We think the reason the Fed accelerated the taper and indicated their intent to raise short rates is simple: Reputation.

Market consensus had recently moved from a $15B/month taper to $30B/month taper and from no rate hikes until late ’23 or ’24 to rate hikes beginning in ’22. The main reason for this was an exchange in late November between Powell and Pennsylvania Senator Pat Toomey who pressed Powell on whether the term transitory was still appropriate. Powell backed away from the argument and the term very quickly, though he did not say that the pre-conditions for easing were met. Most believe Americans are feeling the negative effects of inflation and that the government needs to do something to reign it in. Maybe Powell does too. Either way, a very important job of the Fed is to communicate to the market forward guidance in a clear enough manner that it remains confident in the Fed’s ability to act and react appropriately to economic changes. Not doing so creates unnecessary volatility.

So, after his exchange with Toomey, if Powell did not speed the reduction of liquidity being injected into the economy, and did not indicate rate hikes in ’22, then markets may have taken that as a confusing and contradictory sign, and we could have seen interest rates move appreciably higher. By doing both, the Fed gave the markets what they expected and in fact, long-term rates fell and stocks rallied on the day of the announcement -- success. Some believe Powell will hold back from raising rates until substantial further progress had been made toward “inclusive” employment that reaches all parts of America. It may be this broader lens that got Powell re-nominated and now he needs to speak with a more hawkish tone, appealing to the other side of the aisle to ensure his re-confirmation. Our primary hope is that the Fed does not tighten into

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a soft economic patch and create more havoc than they are trying to prevent. This is our opinion and, of course, others believe labor markets are tight, inflation is high and rising, and the Fed is doing the right thing by raising rates. If they are correct, we expect interest rates will rise and stocks could disappoint.

The biggest risk to next year is that the Fed disappoints the market. Such disappointment could potentially happen in two ways. One way is that the Fed could tighten too fast and too aggressively, thereby causing liquidity to dry up, pushing rates higher and equity multiples lower, while also slowing down the economy. We believe the Fed tightening too fast likely would lead to bad short-term market outcomes, causing losses in both bonds and stocks. We could envision a 20-30% stock market correction in such an environment. That would hurt, but in the realm of history it would actually be a fairly “normal” episode of the Fed taking away the punchbowl. After markets adjust to the new realities, they should resume their normal course of moving up and to the right.

The second possibility is that if the Fed is too slow to reduce liquidity and nudge up short rates it risks losing the confidence of the market. This sort of Fed error could lead to a self-reinforcing cycle of higher inflation and higher inflation expectations. Such a cycle could even be exacerbated by “greenflation”, in which the effort to decarbonize the world by reducing the use of fossil fuels leads to much higher energy prices. We may find ourselves stuck between a rock and a hard place – to keep temperatures from rising by more than 1.5 degrees Celsius we need to spend more money on alternative energy sources and those costs could rise enough to help perpetuate inflation. If the Fed falls behind the curve in such an environment the inflation problem likely will worsen. This outcome could lead to underperformance in financial markets for a much longer period if the adjustment process takes years instead of quarters. To be clear, we do not believe sustained 3% inflation derails markets, but 6% just might. Regardless of the cause, this second scenario is the outcome markets most fear.

Stocks

Will the US stock market continue to outperform the rest of the world in 2022? We do not know but will share a few charts that we believe suggest it might not. We share below the Cyclically Adjusted P/E chart of major regions each quarter during our updates.

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Global Cyclically Adjusted Price/Earnings
Data as of 9/30/2021

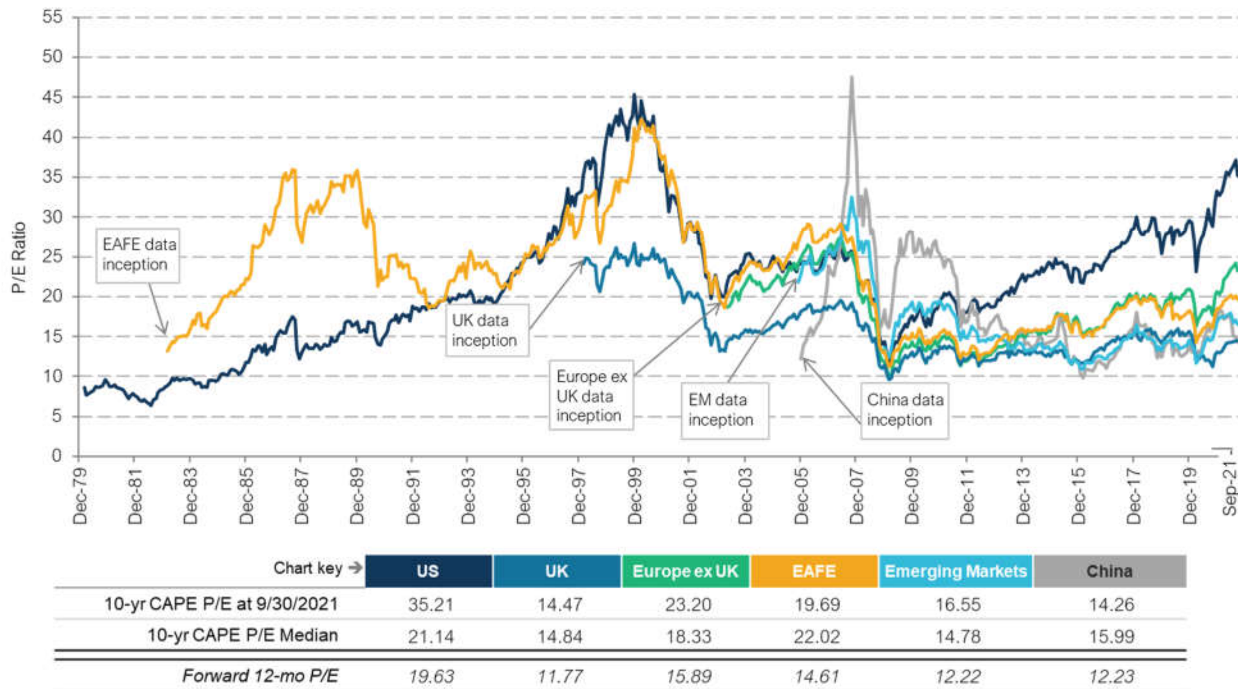

Chart key →	US	UK	Europe ex UK	EAFE	Emerging Markets	China
10-yr CAPE P/E at 9/30/2021	35.21	14.47	23.20	19.69	16.55	14.26
10-yr CAPE P/E Median	21.14	14.84	18.33	22.02	14.78	15.99
Forward 12-mo P/E	*19.63*	*11.77*	*15.89*	*14.61*	*12.22*	*12.23*

Notes. Except for Forward 12-mo P/E data, the exhibit is based on MSCI country price indices and 10-year average earnings per share (inflation adjusted). P/E=price/earnings ratio. Ex=excluding. EAFE= Europe, Australasia, and Far East (developed markets). Data are compiled and supplied quarterly by Ned Davis Research, Inc. Data series inception dates vary; median is calculated from inception if later than 1979. Copyright 2021 Ned Davis Research, Inc. Further distribution prohibited without prior permission. All Rights Reserved. See NDR Disclaimer at www.ndr.com/copyright.html. For data vendor disclaimers see www.ndr.com/vendorinfo/. Forward 12-mo P/E data are based on consensus estimates of forward earnings by stock analysts as reported by Bloomberg on 10/06/2021; price data are based on the S&P 500 and relevant regional MSCI indices.

The US remains the lone region that trades well above historic CAPE levels and above its average forward-looking P/E. The last few years in particular have been pretty spectacular on a relative basis as highlighted below. After oscillating back and forth from 1993 to about 2010, the US stock market has dramatically outperformed the World ex-US market ever since. From January 1, 2010 thru December 10, 2021 the MSCI US Index is +15.2% per annum vs. the rest of the world (MSCI ACWI ex-US) at +6.1%. Very impressive except when compared to the returns of each index from January 1, 2020, through December 10, 2021, of 24.2% vs 9.3%. The US outperformance in the last nearly two years is remarkable.

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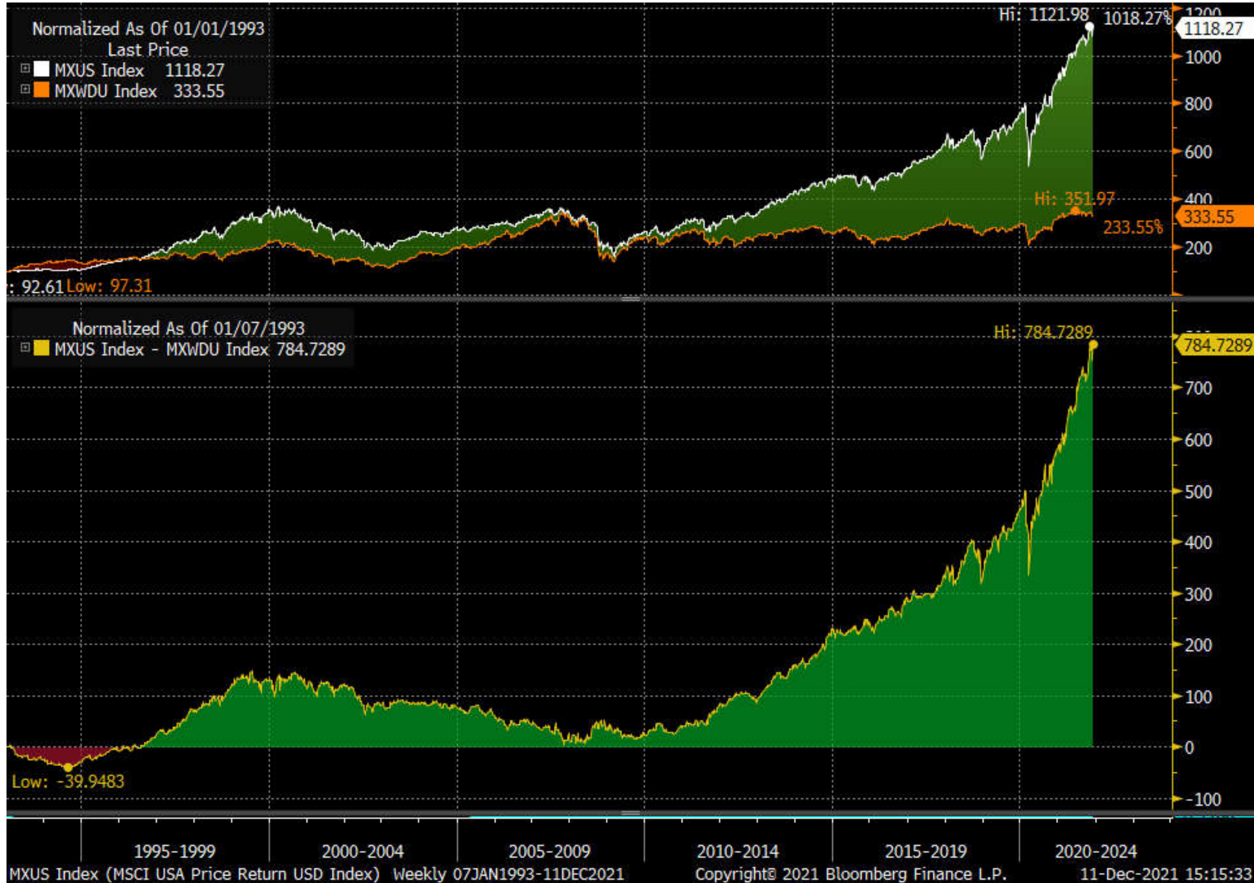

Source: Bloomberg

Rob Arnott of Research Affiliates is a big value proponent. He recently recited the top 10 stocks in the world by market capitalization at the start of every decade. Interestingly, these stocks regularly change. In 1980, half the names on the list were energy stocks due to the oil price bubble. In 1990, only two incumbent names remained in the top 10, with eight of the new top 10 being Japanese – the Japan bubble. Then, in 2000, it was the tech bubble that accounted for half of the names, with only two of the earlier leaders still around. By 2010, only two of the tech winners remained, with eight new names again.

According to https://companiesmarketcap.com/, of the 10 largest stocks in the world today, seven are US tech (or tech enabled) companies, one is a middle eastern energy company, one is a US financial, and one is a Taiwanese semiconductor company. If pressed to identify where the bubble is today, we would point to US technology companies. At this juncture it is hard to imagine what might replace these companies, but history suggests that something else probably will. That might take care of the chart above, and the chart below, which shows the Russell 1000 Growth Index outperforming the Russell 1000 Value Index dramatically from 1978 to December 2021.

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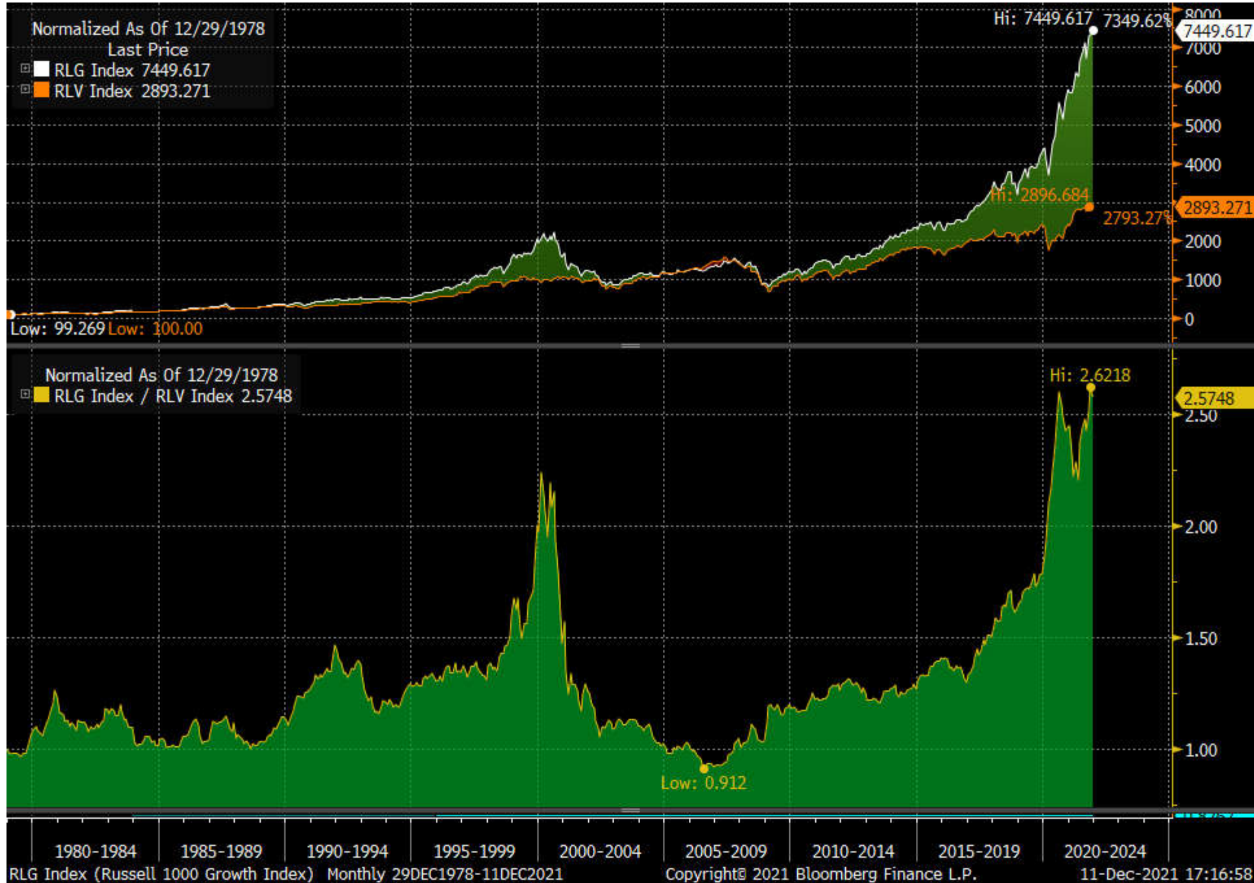

Source: Bloomberg

After oscillating in the 1980's, growth stocks had a massive rally in the late 1990's, climbing to about 2.2 times the level of value stocks before the bubble burst in 2001 and they fell back to below value stocks at .91x. More recently, tech stocks have again trounced value stocks and are back to a return level of 2.62x value stocks for the entire period. This chart covers nearly 45 years. Casual unbiased observers may not fully appreciate the quality and scalability of some of today's great growth companies, but they would certainly notice that those companies have never traded at a higher relative level. The top 7 tech companies in the world by market cap that are based in the US include: Apple, Microsoft, Google, Amazon, Tesla, Facebook, and Nvidia. We'll see if more than 2-3 of them can remain in the top 10 globally over the next decade. Of that, we remain skeptical.

China

We've covered our views on China repeatedly this year, so we will simply hit a few highlights and add a few new thoughts. China is a communist country lead by Xi Jinping who is the General Secretary of the Chinese Communist Party, the Chairman of the Central Military Commission, and the President of the People's Republic of China. When one person holds such vast power, the decision-making process is not nearly as transparent as what we are accustomed to in the West. China's 2021 radical policy changes favoring "common prosperity and national security", with little to no public debate, spooked investors and caused the Chinese market to underperform. Industries and companies that have not acted as the Party requested have been targeted and their stocks have performed extremely poorly. Ultimately, the Chinese stock market was one of the worst performers in the world in 2021.

While transparency is unlikely to improve, we think the direction of change in China will be more positive in 2022. With property speculation clearly on the target list, Evergrande (China's second largest property

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developer) appears headed for bankruptcy. The government appears set to allow this bankruptcy to occur but is also beginning to loosen its grip on the economy and to encourage economic growth for the first time in a year. As we move toward the 20th National Party Congress in the fall of 2022, we expect to see further Chinese governmental efforts to ensure that the Chinese people are happy, much like in other countries where politicians want to be re-elected. These efforts may include further stimulus designed to improve the economy and may also boost stock prices. This stimulus could happen when much of the rest of the world is in tightening mode. Central banks in the US and elsewhere may be tightening while the China Central Bank is easing. This policy divergence would likely help the Chinese equity markets to perform relatively better. Finally, it is worth recalling that historically most Chinese savings have gone into bank accounts and real estate. The Chinese stock market is fairly new and not yet broadly held the way it is in the West, especially in the US. The Chinese government may be encouraging capital formation in equities to help de-lever its economy. If so, it is an unspoken objective. It could also represent a fundamental shift in the flow of funds within the second largest economy in the world, leading to much more robust equity markets in the future. Time will tell, but either way China looks set to perform better in 2022.

This chart shows that Chinese stocks (white line) have been more volatile and fared generally better than the MSCI ACWI since we first invested in them - until recently.

Source: Bloomberg

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Lastly, COVID

We certainly are not epidemiologists, scientists, or even doctors. We are mere students of markets, and therefore, of history. We do know that investors are now well aware of this scourge. It is global, and it is indiscriminate. Local government reactions have been different to this point, but with few exceptions most countries are learning how to cope with it better by the day. This adaptation process is in keeping with how investors and markets handle any new risk. As time passes, they become more familiar with it and investors position their portfolios to benefit from changes in the risk level (or at least to minimize harm). Over time the market gyrations associated with the new risk become more muted until, finally, they essentially disappear. Gyrations can, of course, return if something much worse than expected comes to pass, but for the most part the underlying risk becomes fully incorporated into the market. We believe that we are almost there today.

The most recent Omicron variant also seems to be doing what viruses do, which is to say they morph. Their goal, like humans, is to live and to propagate. For a virus, this means to become more contagious and less deadly. You want to spread, but not end up killing your host, taking you with them. Early Omicron data suggests that this variant may be doing both. It is outcompeting the Delta variant, but vaccinated victims' symptoms are, so far, milder with fewer serious hospitalizations, ICU stays, and most importantly fewer deaths. The great hope is that this latest COVID chapter will soon come to a close with a plausible worst-case outcome becoming the need to be vaccinated annually along with our flu shots to minimize the impacts of the then-current COVID strain.

2022 Positioning

If these are the big investment questions of 2022, you may be wondering how we are positioned. We agree with consensus economic forecasts of above average 4% or so global (and US) GDP growth next year. We do not think inflation will get out of hand, and we do not think the Fed will need to tighten excessively to prevent sustained inflation. As the demand bulge fades and supply chain issues abate, we believe inflation will moderate back toward the Fed's 2% target by the end of 2022. In this environment we think global equities can have another decent year. We believe earnings are likely to grow by 10% plus, allowing multiples to contract while still providing positive returns. With nothing explicit to point to (regulation and taxes?), we are more nervous about the ability of the U.S., and big U.S. tech stocks in particular, to outperform again in 2022. For this reason, we remain well diversified around the world. Our weights in the US are a little below the cyclically high ACWI weight of 60%. Elsewhere we are generally at or slightly above benchmark weights. We are looking for an opportunity to increase our weight in China as we expect it could be a much better market next year and our managers in China continue to add alpha. It's sometimes hard to remember that in China volatility is actually our friend because our active managers are able to use fear and greed to their potential advantage.

In other asset categories, we expect 2022 could be another decent year for hedge funds. We will try to keep our hedge funds' beta to equities at about 0.3x and we will be vigilant that our manager return streams are not highly correlated to one another. In 2022, we may even start to read about how much better hedge funds are than bonds.

Finally, we will continue to avoid fixed income as much as reasonably possible. The chart on real rates above tells you about all we think you need to know. A bond cannot grow earnings, it has a fixed coupon, and current bond prices are extremely high. Accordingly, we believe that now is a good time to borrow money to buy a productive asset you need, not lend to someone else. We are not expecting a disaster in bonds, just nothing good and maybe something not so good. So, it probably will not be as easy in 2022 as it has been (with hindsight) the last couple of years to meet your financial goals, but we do think '22 should be another good year to stay invested in stocks where you can make the returns needed to meet your long-term financial goals.

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We do expect more volatility, but that is why equity investors make superior returns over the long run. As we said at the start of this letter, here's to a much less exciting 2022.

As always, we sincerely appreciate the opportunity to help you manage your capital and to achieve your organization's financial goals. We are here to assist you, so please do not hesitate to contact us. We wish you a safe, happy, and healthy 2022.

Your TIFF Investment Team

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