Verus

Sound Thinking

IAN TONER, CFA
CHIEF INVESTMENT OFFICER

2022: Back towards normal?

January 2022

As we do every year, during January we sit down to think about what might matter for the coming year – and that process always begins with us assessing how we did the previous year. The goal of this is to help boards prioritize their work, whether it is actually allocating money or simply setting the agenda of topics they should be thinking about. 2022 is already off with a bang, and 2021 felt at times as though it was a year with about 35 months. So how did we do in terms of our focus topics in the last year?

2021 - How did we do?

The topics we focused on were as follows:

1. **Investing Is Hard**

   This focused on the challenges faced by investors in the ultra-low interest rate environment, with bonds providing less effective diversification than in the past – our advice was not to try to replace them with a single asset, but to think broadly. We expected the risk and return diversifying benefits of a long-term bond allocation in an equity portfolio to be weaker than the average experienced over the last 20 years, and this turned out to be accurate. The average Sharpe Ratio improvement to an equity portfolio caused by including 40% allocation to bonds over the last 20 years was about 0.16. During 2021, including bonds not only was less advantageous – it actually ***decreased*** the Sharpe Ratio of the portfolio by 0.24!

2. **The Charles Montgomery Burns Market**

   We described the market as being in a delicate balance, with a combination of lax fiscal and monetary policy and a range of other government support mechanisms allowing for continued strong performance of risk assets. We suggested that this was unlikely to be sustainable over the long term and that there would be a chance of quick market sell-offs during the year as markets focused on the probability of stimulus coming to an end. This accurately described market behavior for the year. Unexpectedly strong earnings provided some buffer to concerns over the path of interest rates and levels of future government support. Although risk assets delivered exceptional performance during the year on the whole, we can count this as a success.

3. **Really? Estate**

   We suggested that the impact of Covid on the economy would take a long time to work through real estate portfolios, and that investors should focus on discussions with their managers to try to assess the likely impacts rather than precipitous change. This was helpful advice during 2021. There were few signs of actual crisis in the real estate market as a whole, and investors who recoiled in fear from the marketplace would likely have regretted that decision. We can count this theme, then, as a success too.

4. **Chaotic To Kinetic**

   We suggested that the transition from Trump to Biden in foreign policy terms would be more of a move back to the status quo ante. The Trump period was characterized by chaotic tweeting combined with relatively non-interventionist policy, but it seemed likely Biden's first year would be more traditional in terms of messaging and more interventionist in terms of policy. We were partially right in this. While the messaging from Washington has generally been more traditional, the Biden administration has been less interventionist than might normally have been the case – choosing to withdraw from Afghanistan in relative haste, for example, rather than to make the call to reverse the decision to leave and instead commit more forces. This means we were partially right in this call.

5. **Churchill Was Right**

   This idea suggested that one party control of the legislative and executive branches of government would not necessarily translate to easy consensus and a strong agenda for action. In practice, the wide range of views within the Democratic Party and a very slim majority in the Senate ensured that the environment in D.C. was one of stalemate not rapid progress. This can be counted as accurate.

6. **Inflation Eventually**

   While we recognized that there was the chance of a significant rise in inflation and recognized that the effects of Covid on the supply chain in particular were significant, our view at the start of the year was that inflation was likely to stay relatively low. This was a clear miss. We did identify the problems in the supply chain, but we did not forecast how significant these would become, and how much their instabilities would impact pricing in the economy. Our skepticism was appropriate, but the effect of this disruption was larger than we expected.

7. **Functionally Focused Thinking**

   We suggested that the changes in the investment environment we were seeing indicated that a functionally focused portfolio approach merited a place on board agendas. This was not really a forecast – more an agenda suggestion – so we can assign neither success nor failure. However, this idea correctly reflected the changing characteristics of asset classes during the year and would likely have benefited Boards that adopted the approach.

8. **Crypto-Confusion**

   We suggested that 2021 was a good year for investors to educate themselves about the crypto-currency space. We also predicted that although the crypto world would become more mainstream, the core regulatory guidance needed for fiduciaries to feel fully comfortable investing directly in the space would still be lacking by year end. This remains the case – although some investors may have some exposure embedded within hedge funds or private market elements of their portfolios and the volume of discussion of the space has increased, most fiduciaries remain appropriately at arms-length from what is still a nascent and high-risk market. We can count this prediction as a success.

9. **China Isn't Going Away**

   We proposed that greater tensions between China and the USA were not simply artefacts caused by the Trump administration, but instead represented the new normal relationship between the world's preeminent revisionist and status quo states. This was clearly the correct analysis – rather than a sudden thaw under the new U.S. administration, there remains a chill, and this is likely to continue and indeed has the potential to escalate as relations over Taiwan and human rights deteriorate. We can count this as correct.

10. **Thinking Harder & Better**

    Less a prediction than other ideas, we suggested that 2021 was a year where investors would have to up their game. We thought that investors who were able to think more holistically about their investments, considering a range of possible options rather than simply making assumptions based on past experience, would be better placed to navigate the challenges of markets in 2021. This is difficult to grade, so we will exclude this from rating.

We can then give ourselves a grade of six out of the eight gradeable opinions being accurate. One – the view on inflation – was clearly wrong, though the overshoot in inflation was due to the disruption we were concerned about but underestimated the impact of. The second view was half-correct. The other topics (Functionally Focused Thinking, and Thinking Harder and Better) were not easily able to be graded so can be excluded. Overall this is a prediction rate we are fairly pleased with.

So much for 2021. What can we expect for 2022?

Again, the task we set ourselves is not simply market predictions, but also broader topics and issues that we believe deserve Board time and attention during 2022. They are as follows:

1. Supply chains: Normalizing not normalized
2. Inflation: Lower not lowest
3. Rates: Higher not high
4. Risk assets: Moderately positive
5. Private markets: 10 years not one year
6. Politics: Disagreeing to disagree

7. China: Still an issue
8. Models: Numbers remain broken
9. Real estate: Slow change, some opportunity
10. ESG: Adding the you

Now on to the detail on each of these.

SUPPLY CHAINS: NORMALIZING NOT NORMALIZED

One of the biggest challenges the world faced in 2021 was the massive disruption in supply chain networks. Our calls during the first half of the year with investment managers and researchers to try to understand this topic were unhelpful: the scale of disruption was deeper, wider, and more significant than was predicted by almost anyone. The supply chain structure built up over the previous 30 years was designed for maximum efficiency and profitability, but not for stability. In 2022 the existing, less stable system will slowly come back into a more normal balance, but that process will likely take most of the year. By year-end we expect to see Trans-Pacific trade running more smoothly, with prices for the major routes closer to pre-Covid rates. We also believe that we are only at the beginning of the process of "fattening" of the supply chain: each step of the supply chain being made a little more resilient, with more attention on the stability of supply and less on the maximal efficiency at each step. This may mean more manufacturing locations, manufacturing closer to point of use, more robust transportation infrastructure, or more storage of goods closer to point of consumption. This is likely to have complex implications: a slight push on inflation, a slight increase in spending throughout the infrastructure chain, a slight increase in propensity for domestic rather than distant investment in manufacturing, and so on. None of these are likely to have a massive individual impact – taken together, however, they may leave the global economy with a more costly but more stable supply infrastructure.

INFLATION: LOWER NOT LOWEST

We believe that the rate of inflation will fall materially in 2022, but not to the levels of the recent past. Inflation is a year-on-year measure: high prices that are not changing rapidly produce low inflation numbers. This year-on-year characteristic will become more important in 2022, particularly in the inflation components, like energy and used cars, that have had larger impacts in 2021. Some of these areas will also be affected by potential supply chain improvements, although there will continue to be strange pricing effects for some goods (though this will likely be a smaller factor in 2022 than 2021). Despite these views, inflation remains a major concern. Some significant components of the inflation basket – especially shelter costs – are likely to continue to run hot. Changes in behavior across the working-age population (specifically the lower participation rate due to unusually high retirements in older workers) may well drive prolonged wage price inflation pressure. This means that many variables other than simply monetary policy are contributing to higher prices[1]. While inflation fears of certain

1. *Much of the talk over the last 10 to 15 years about monetary policy has been around the dangers of inflation of easy money. While we are very sympathetic to that view, the reality is that the link over that period has been very loose indeed. The fact that inflation is now here, and that it arrived at the same time as supply chain disruption, suggests that the connection in this instance between the new inflation and new supply chain disruption is likely stronger than that between overly-loose money, which has been in place for more than a decade, and sudden inflation*

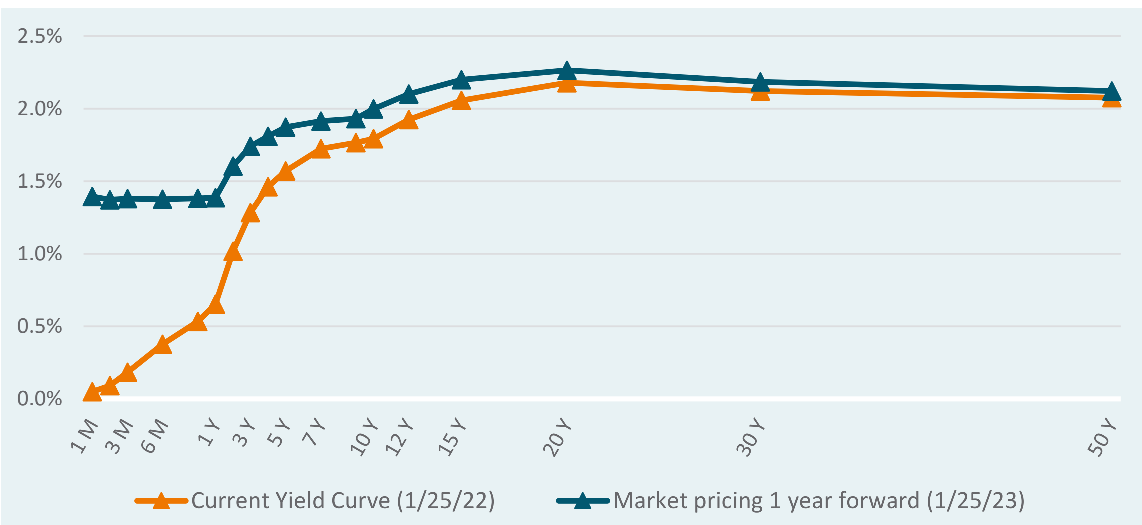
past economic cycles revolved around monetary policy, the current environment is particularly fueled by supply chain and shut-down issues. We believe that concerns around stubborn inflation are legitimate, and it would be surprising to see inflation below the mid 3% range by year-end.

RATES: HIGHER NOT HIGH

It is clear that interest rates will be rising during 2022. Investors need to think hard about whether more rate rises will occur than that which is currently priced in by the market, as only small central bank-driven changes in very short-term bond rates (leaving the rest of the yield curve potentially little changed) are currently expected. This needs to be unpicked a little.

We need to think about the incentives and goals of central banks. Central banks want to tighten money supply towards more normal levels, but without breaking economic growth. This means central banks are focused on reducing their purchases in the market (shrinking their balance sheets or at least reducing the pace at which their balance sheet grows) and increasing the interest rates that they control: the very short-term interest rates. Central banks have no specific control over long-term interest rates other than through direct market intervention and the strategic use of press releases.

So what are market participants, who are the actors with the greatest influence on the pricing of those long-term bonds, saying about the prices at which they are prepared to transact? As we can see in the chart below, while market participants do expect short-term interest rates to move up somewhat, there seems to be little anticipation of longer-term rates increases. This suggests that there is only limited scope for short-term rates to move up in the current environment without creating a yield curve inversion – often seen as the sign of a coming recession.



Source: Verus, Bloomberg, as of 1/25/22

From a U.S. standpoint it is also important to note that the U.S. market is one of the highest carry markets in the world for government bonds. This means that there is only limited practical capacity for rates to increase: once they rise past a certain level, international capital will flow into the U.S. market as the opportunity becomes more and more attractive. That inflow of capital will raise bond prices and therefore put downward pressure on yields.

Taking all of this into account, the conclusion we can draw is as follows. We may be in a "rising rate environment" but there is a material chance that this could be mainly confined to shorter-term interest rates, and may flatten the yield curve. Current prices reflect most of the likely moves here, so it may not be a particularly investible theme for 2022. Indeed, the standard advice (shorten duration in a rising rate environment) may be counterintuitively unhelpful if the shorter end of the curve is the place where the rising rates are concentrated (and, additionally, the prices of those shorter-term bonds may already be priced for higher rates). We should be mindful, at the same time, that the possibility of significantly higher rates over the year is not zero. It is entirely possible that both central banks and investors determine that we have entered a different phase state of the economy. Investors should understand the likely effect on their portfolios were this scenario to come about.

RISK ASSETS: MODERATELY POSITIVE

As stated above, we think that a fairly benevolent environment for interest rates and for economic activity may well continue, tempered by continued input cost pricing challenges, including wage costs, and supply chain issues. With margins and earnings at very high levels, and rates likely to go up somewhat rather than down, it seems less probable that investors will receive the super-returns of previous years (large parts of the "out of covid" relief rally have happened already). Strong earnings were a major surprise during the past year with cost cutting improving operational leverage and profit margins as companies became leaner. This trend is unlikely to continue, and blowout earnings are less likely to underpin equity markets and dampen volatility in the way that they did during 2021. There may be periods of pain for risk assets as we go through the typical cycles of "bad news is bad news" turning into "bad news is good news": we can expect at least a normal number of 5% down-draft events in risk assets to occur during the year.

PRIVATE MARKETS: TEN YEARS NOT ONE YEAR

2021 was an exceptional year for many private market portfolios. That creates some issues for boards to consider during 2022. In particular we should remember that for these long-term portfolios the goal is to produce long-term high returns over the life of the investment. A single great year followed by a long period of mediocrity will not deliver the types of long-term returns that investors need from these exposures. There are also some challenges caused by one year of exceptional returns when looking at the total portfolio level: does it cause a temporary imbalance in allocations, and if so what should the investor do about it? Looking through short-term results, high valuations and significant cash raising efforts from managers, and sticking to the long-term pacing schedule generally remains the appropriate course of action.

POLITICS: DISAGREEING TO DISAGREE

The word dysfunctional is likely to be used frequently during 2022 when discussing U.S. politics, but market implications from that dysfunction may be minor. This is a mid-term election year and public sentiment does not seem particularly aligned with the party in control of both Legislative and Executive

Branches. Additionally, neither party appears particularly internally united. This suggests a low chance of success for any set of truly radical policies. It seems more likely that this will be an even more fractious political year than usual, with a focus on social issues being important, and with real challenges to any major legislative change. Markets are unlikely to get a boost during the year from major legislative wins. However, markets are often relatively happy under divided government – this means that later in 2022 the prospect of Republican gains in both House and Senate could provide some market support. This is not because of specific policies being proposed, nor because we believe one set of policies is inherently better than the other, but simply because it may represent a move towards a more divided government for the last half of the Biden administration's first term. This could, ironically, produce a climate more conducive to some degree of compromise on key issues where action is needed.

CHINA: STILL AN ISSUE

China remains an extremely important part of the picture for investors in 2022. The relationship between China and the U.S. is more marked by competition and mistrust than was the case ten years ago. The structural shift in that relationship occurred throughout the Trump administration and is more of a permanent refocus than a temporary blip. China's relationships with the rest of the world are also more assertive than before. This strategic competition presents material geopolitical risks. While it is still unlikely that those risks boil over (for example, into an invasion of Taiwan or greater hostility with India over their common border) investors need to note the possibility of a major power using physical force for expansionary reasons exists. This matters because of the role that China has played in global trade and global growth (saber rattling from Russia has the potential to be destabilizing, but the economic importance of China for the world is materially greater).

China's size remains important for investors, and with continuing growth this will increase. This is particularly evident in Emerging Equity portfolios: poor performance recently can be laid mostly at the feet of the China exposure. For some sophisticated investors 2022 may be a year to reconsider the way that they achieve their Emerging Markets exposure. Rather than a simple naïve inclusion in an Emerging Market allocation, investors may find it worthwhile to consider some stand-alone exposures to onshore elements of the China opportunity with managers who have demonstrated capabilities in that space, while reducing some of the exposure wrapped into broader Emerging Market indexes. U.S. investors need to be aware that the onshore element of this investment is a long-term bet on the growth of the China opportunity, and that their financial interests are a low priority for the Chinese government. However, there are likely long-term opportunities available for those investors prepared to suffer those risks[2]. Such allocations would likely come with a reduction of the allocations to China within broader Emerging Market portfolios. The remaining parts of Emerging Market portfolios would stand to benefit from a continued diversification away from China as a supplier for the global markets (a trend that has been apparent in recent years).

One final issue is going to be important for 2022: ethical issues. It is likely, as the broader discussion over ESG issues increases, that the ethical questions involved with investing in China will gain more focus. These issues are real, and important: investors who have not spent material time understanding them and considering how they square them with their own values are well advised to spend that time

2. *This would apply, of course, to the most sophisticated investors with the scale and staff needed to implement this decision*

soon. This suggestion is not prejudging the outcome of that consideration - our job here as elsewhere is to help investors understand how their own values impact their investments – but the issues involved are real and have potential regulatory implications. Every investor should understand their exposures and should be comfortable with them.

MODELS: NUMBERS REMAIN BROKEN

We have said throughout the Covid crisis that one of the most important, but least appreciated, consequences of that crisis is how badly it has broken the data sets on which investors build economic models of the world. Many of those models have become massively less reliable. It will likely take 5 years for things to get back to normal – maybe even as many as 10. Until then we will have to deal with very odd data. When we look at averages, those averages will include both the Covid distortions, and the after effects of interest rates being close to zero for a very long time indeed. When we look at the reaction of markets to news or economic difficulties, the data will include the result of the massive fiscal and monetary support that we saw over the last two years. Some data series such as initial jobless claims are going to be extremely distorted for a very long time, for example. What was seen as a big move in that number during the 2011-2019 period (say, initial claims rising from 230K to 245K) would now be seen as a tiny change. With the data on average behavior broken, and with most year-on-year calculations thrown off kilter in a huge way, and with many historically-stable economic relationships distorted, care will be needed for the foreseeable future whenever an investment sage leans back in their chair and begins to predict the future based on data from the recent past. The impact on investors is simple: they need to be even more careful than usual to make sure they understand these uncertainties and how they might be affecting their advisor's predictions. They should keep asking questions to better understand the ways that forecasts have been corrected for strange data effects of the Covid experience.

REAL ESTATE: SLOW CHANGE, SOME OPPORTUNITY

During the last two years there has been a lot of discussion about the long-term impact of Covid on the real estate market. The rise of remote working has raised the possibility of major changes in real estate consumption patterns. Will companies need less office space? Will the space needed for each employee change (either reduced, because fewer are likely to be in the office at any particular moment, or increased due to greater sensitivity to the possibility of infectious disease transmission)? Will housing consumption focus on moving to entirely different cities to work remotely, or movement further out to suburbs for a longer commute a few days of the week? Or will the move be the other way – back to the central cities, to keep proximity to the facilities cities offer, but to less of a commute?

The answer, of course, is that it is too early to tell. Residential real estate has certainly seen changes in demand, with the new economy providing a boost to some smaller cities, and to suburbs. But there is also some evidence in certain places of a resurgence in demand for city-center accommodation. Office leases are on such a slow cycle that it will take years to get a clear picture – but we will be watching carefully as information comes through about occupancy changes and pricing over the next eighteen months, particularly if it begins to cause buildings to fall into distress. Industrial real estate has been strong, and continues to be promising, with the fattening of the supply chain likely to cause continued demand, and with that demand being spread more broadly than usual.

Investors should be careful not to act precipitously: real estate is a long-term asset class, primarily private, and does not allow for easy tactical movement for institutional investors. In investors should watch for opportunity – particularly in focused strategies where the manager has shown the ability to generate value in a way that aligns with the changes we are seeing. It will also be worth paying attention to signs of distress in existing strategies, particularly those thought to be highly secure.

ESG: ADDING THE YOU

The final area of focus for investors this year is ESG. As we have said before, we do not believe that it is for Verus to dictate values or beliefs of our clients. We should instead help them understand whether, and how, those beliefs may have an impact on the portfolio. Getting consensus on these issues can be hard, and for a board to move forward takes work building consensus. This will likely leave no-one at the table feeling entirely happy, but also no-one at the table feeling entirely ignored. These conversations will continue during 2022, and for many investors they may well be an important agenda item for board meetings, especially as the regulatory environment for ESG is changing rapidly. The key to these conversations being effective, though, is customization. The end result needs to actually align with the needs of the investor, rather than simply being a cookie-cutter approach that standardizes the decisions. This is harder to achieve for smaller investors than for larger ones for a range of reasons, including costs. A good sign is the emergence of a more customized approach to proxy voting, and other similar elements of the process, with investment managers beginning to provide some degree of flexibility for the end investor in how their votes are used in advocacy. Many investors could usefully spend time in 2022 encouraging this progress and working to understand the role that ESG may play in their own process (noting that the result of this discussion may range, entirely acceptably, from not-at-all for some investors to everywhere-possible for others).

Conclusion

We expect 2022 to be a challenging year. The markets may well be at an inflection point, with inflation poised to stay elevated for longer than hoped, and (shorter-term) interest rates possibly poised for an ongoing upward move. Neither of these moves are guaranteed, however, and there is significantly more than the usual level of uncertainty for investors. We believe boards that focus on the topics above will be better positioned than their peers to meet the challenges of 2022. We would look forward to hearing your reactions – and more important your disagreements – with these insights.

ABOUT THE AUTHOR

Mr. Toner has a degree in Law from the University of Oxford in the United Kingdom and is a CFA charterholder (Chartered Financial Analyst). He is a regular author and speaker on a range of investment topics. He is a member of the Audit / Finance Committee of The Medina Foundation in Seattle. He is also a member of the CFA Institute and the CFA Society of Seattle. He is a former board member at the Seattle Metropolitan Chamber of Commerce, where he co-chaired the finance & audit committee. Mr. Toner was formerly a trustee of the Charles Wright Academy and former chair of the endowment committee. He has been happily married to his wife, Heather, for over 25 years, and is the proud father of two children.

IAN TONER, CFA
Chief Investment Officer

ABOUT VERUS

Verus Advisory, Inc. (Verus) is an independent, employee-owned provider of non-discretionary consulting and discretionary management (OCIO) services since 1986.

Verus®
800 Fifth Avenue, Suite 3900
Seattle, Washington 98104
206-622-3700
verusinvestments.com