John M. Longo, PhD, CFA
Chief Investment Officer,
Beacon Trust
jlongo@beacontrust.com

A LOOK AT THE YEAR AHEAD: Ten Investment Forecasts and Four Strategic Wealth Management Themes to Capitalize on Them

December 2021

As we acknowledge each December in presenting our outlook for the coming year, no one can know the unknowable or predict the unpredictable. But, as wealth managers, it is our job to analyze the world around us and invest in the context of the short- and intermediate-term economic landscapes. We have never believed in a "one size fits all" portfolio and have always provided custom tailored advice to our valued clients based on their personal goals and risk tolerances. With this in mind, we would like to share with you our perspective and predictions about some significant events that we believe are likely to unfold in the year ahead.

Beacon's Ten Investment Forecasts for 2022

1. U.S. stocks will outperform bonds, but their returns will be below their long-term averages.
2. The Federal Reserve will raise short-term interest rates in 2022.
3. Inflation, as measured by the Consumer Price Index, will exceed the Fed's 2% target in 2022.
4. Consumer confidence will increase in 2022, as the COVID-19 pandemic slowly recedes.
5. There will be a stock market correction in 2022, but it may represent a buying opportunity.
6. The benchmark 10-Year U.S. Treasury Note will increase from its current level of 1.45%.
7. International equities will outperform domestic ones, in aggregate, as the rest of the global economy plays "catch up" to the U.S.
8. Hedge funds, private equity, and liquid alternative assets will increase in aggregate as investors diversify from negative real bond yields.
9. Cryptocurrency assets will increase in the aggregate and Web 3.0 will proliferate.
10. The midterm congressional elections will result in a balance of power between Democrats and Republicans, informally known as "gridlock."

Beacon's Four Strategic Wealth Management Themes for 2022

Beacon's Four Strategic Wealth Management Themes for 2022 echo our forecasts for the coming year and reflect our best thinking to protect capital and improve returns:

1. Temper return expectations after abnormally high recent performance.
2. Seek alternatives to negative real bond yields amid a Federal Reserve tightening cycle.
3. Invest for a changing world order.
4. Ride the secular waves of technology, infrastructure, clean energy, and demographics

A Glance Back on the Year That Was

U.S. stocks had another fantastic year with the S&P 500 increasing more than 25% in 2021, as of the time of this writing, fueled by strong earnings, an accommodative Federal Reserve, and robust fiscal spending. COVID-19 is still with us, but market participants are clearly looking ahead. Bonds were another story, serving as ballast for diversified portfolios when stocks fell, but most investment grade bonds ended the year slightly in the red. For example, the Barclays Aggregate ("The Agg") fell about 1.7% in 2021 thus far, negatively impacted by the rise in intermediate to long-term interest rates amid sharply rising inflation.

Before we look ahead to 2022, it seems only fair to look back on our 10 forecasts for 2021. What did we get correct and where did we go wrong? In our view, six of our ten predictions were correct, two partially correct, and two incorrect. We usually have a fairly good batting average with our predictions, but it was an unusually accurate year. We hope our prognostications for 2022 will be at least as prescient.

Let's start with our mistakes, which we always try to learn from. We thought economic growth would accelerate in the second half of 2021 as most of the country became vaccinated against COVID-19 and things slowly returned to "normal." However, the Delta and Omicron variants of COVID-19 have muted economic growth in 2021H2, along with unexpected supply chain problems that have crimped global trade. We also forecasted that investment grade bonds would deliver coupon-like returns, or at least keep above water. As noted above, The Agg fell 1.7% in 2021. A near miss, but still a miss.

Let's move on to our clairvoyant calls from 2021. We predicted 2021 would be a good year for U.S. and international equities. Indeed, it was, with the S&P 500 increasing 27% and MSCI International Index up 9%, so far in 2021. We forecasted the Fed would remain on its hands concerning raising short-term interest rates. They were, but 2022 may be another story. We predicted a series of successful vaccines would get the U.S. back closer to normal. Of course, things aren't perfect, but GDP is higher than it was prior to the pandemic, most kids are in school, sports stadiums are full, and people are on airplanes and cruise ships in somewhat close to full force.

We predicted a robust year for the earnings of S&P 500 stocks. S&P 500 earnings surged roughly 40% in 2021, sharply rebounding from depressed early pandemic era numbers. We forecasted a decline in volatility in 2021 versus the prior year. 2021 has been abnormally benign with the largest intra-year drop for the S&P 500 equal to only 5%. VIX, another measure of volatility, has fallen roughly 15% over the course of the 2021 calendar year. Lastly, for our correct 2021 predictions, we forecasted that U.S. unemployment would fall. It fell meaningfully from 6.7% to 4.2% over the year.

In terms of our partially correct forecasts, we predicted Cyclicals would outperform Big Tech and the "stay at home stocks" (SAHS) that led the 2020 market rally. Our forecast was a mixed bag. The quintessential stay at home stocks, Zoom, Teledoc and Peloton, plunged 45%, 53%, and 75%, respectively, so far in 2021. Energy stocks, part of the Cyclical trade, have been the best performing sector in the S&P 500, increasing more than 50%. However, the FANG mega cap Tech stocks had another strong year, with Facebook up 21%, Amazon up 6%, Netflix up 17%, and Google/Alphabet up 70%. Real estate prices increased and remained hot, in contrast to our expectations of a moderation in price increases. **Table 1** provides a summary scorecard for our 2021 forecasts.

Table 1: Review of Beacon's 2021 Financial Forecasts

Forecast	Assessment	Rationale for Assessment
U.S. and International stocks Increase	Correct	S&P 500 up 27%, MSCI International up 9%
The Fed will not raise interest rates	Correct	The Fed did not raise rates in 2021
Vaccines will get economy close to normal	Correct	3 vaccines were distributed; GDP higher than 2019-20
S&P 500 earnings increase 10%+	Correct	S&P 500 earnings increased ~40% YOY
Economic growth will accelerate over the year	Incorrect	2021H2 slowed vs. H1 due to Delta and supply problems
2021 volatility < 2020 volatility	Correct	Biggest 2021 drawdown only 5%; VIX fell ~15% YOY
Cyclicals outperform Tech, stay at home stocks	Partially Correct	Energy did the best, Tech did well, many SAHS fell
Real estate increases in 2021, slower rate	Partially Correct	Real estate prices increased, but remained red hot
IG bonds provide coupon like returns	Incorrect	Most IG bonds experienced modest losses
Unemployment rate declines	Correct	The unemployment rate fell from 6.7% to 4.2%

A Closer Look at Beacon's Ten Investment Forecasts for 2022

There is an element of risk in offering predictions since the future is uncertain. We can state with confidence that some forecasts we offer for 2022 are again likely to be correct, some incorrect, and some partially correct. We can also predict with great confidence that what will ultimately prove to be some of the major events of 2022 are neither on our list, nor likely on anyone else's. Clearly, few people foresaw the devastating COVID-19 pandemic emerging in late 2019 as well as the wide-ranging supply chain turmoil that many industries are still grappling with today. It is often the events that few investment strategists are talking about that result in the most extreme market movements.

As noted in our Executive Summary section, Beacon portfolios are custom tailored to each client's unique risk tolerance. Hence, our investment ideas may be appropriate for some clients, while not consistent with the goals and objectives of others. With these important caveats in mind, we humbly offer you some color around our top ten investment forecasts for 2022.

1. **U.S. stocks will outperform bonds, but their returns will be below their long-term averages.**

   Stocks have been on a tear since the depths of the Great Recession, despite the inevitable road bumps, compounding at a rate of almost 16% per year since 2009. This figure is more than 50% higher than long-term stock returns of roughly 10.5% per year since 1926. Given a backdrop of elevated valuation levels, rising interest rates, increasing taxes, and more difficult earnings comparisons, it may be time for U.S. stocks to take a breather. However, it is hard to see a flood of money rushing into bonds when their yields are dramatically below the rate of inflation. The return outlook for conventional asset classes may be more muted in 2022, which has led us to increase our efforts looking at alternative and international assets.

2. **The Federal Reserve will raise short-term interest rates in 2022.**

   The Federal Reserve promptly cut short-term interest rates to 0% when the COVID-19 pandemic arrived on U.S. shores in early 2020. Concomitantly, it engaged in a massive, ongoing quantitative easing (QE) program. The Fed's latest round of QE has expanded its balance sheet from about $4 trillion to $8 trillion. With the unemployment rate falling from 6.7% to 4.2% over the past year, the Fed will now set its focus on the second element of its dual mandate, stable prices. To get inflation under control we believe the Fed's hand will be forced to raise the Federal Funds Rate in 2021. Futures markets are currently pricing in increases of 0.75% in 2022 with the first increase expected around midyear.

3. **Inflation, as measured by the Consumer Price Index, will exceed the Fed's 2% target in 2022.**

   The latest inflation print was 6.8%, the highest reading for the Consumer Price Index (CPI) since 1982. Only recently, Fed Chairman, Jay Powell, suggested that the "transitory" label for inflation be retired. Houston, we have a problem. Its name is inflation. One reason for the high levels of inflation is known as the base effect.

That is, part of the inflation calculation involves a 12-month rolling or moving average of its components. Some of the abnormally low numbers from the depths of the COVID-19 pandemic are now rolling off, being replaced with normalized readings. However, part of the high inflation readings is very real and not an artifact of the CPI's arcane calculations. Chief among them are real estate prices. The most popular real estate index, S&P Case Shiller, is up roughly 20% over the past year. Yet, the CPI calculation for housing doesn't track Case Shiller, but rather something known as "owners' equivalent rent." Many owners were prevented from raising the rent or evicting non-paying tenants during the COVID-19 pandemic. These legal protections are expiring in many areas, likely pressuring the CPI upward in 2022. Furthermore, the ongoing global supply chain problems provide a textbook case of Economics 101. That is, if demand stays the same or increases, and supply decreases, prices increase. We may have to live with elevated inflation readings for at least another year.

4. Consumer confidence will increase in 2022, as the COVID-19 pandemic slowly recedes.

A plunging unemployment rate and record high stock and real estate prices suggest that consumer confidence readings should be fairly high. In contrast, according to the University of Michigan Consumer Sentiment survey, consumer sentiment remains near a 10-year low. Why the disconnect? Of course, the elephant in the room is the ongoing COVID-19 pandemic and its multitude of variants, along with the aforementioned highest inflation reading in decades. In our view, continued progress will be made on both fronts, although problems will not disappear overnight. Accordingly, consumer confidence should rebound over the course of 2022.

5. There will be a stock market correction in 2022, but it may represent a buying opportunity.

America has become accustomed to dealing with whatever challenges the world throws at it, with the financial markets ultimately climbing the proverbial "wall of worry." The S&P 500, currently at record highs, has not experienced a 10%+ correction since the depths of the COVID-19 pandemic in March of 2020. Historically, stocks have a correction, on average, every nineteen months. We are currently past that threshold, so statistically speaking, we are "due" for a correction, and the odds of going another 12 months without another one is fairly low. Of course, it is difficult to pinpoint the exact timing and source of any market pullbacks. Current risks include the ongoing COVID-19 pandemic, geopolitical tensions with Russia and China as well as the economic challenges of higher inflation, interest rates, and taxes. "Black swan" risks, unexpected events with potentially severe economic consequences, always lurk in the shadows. As in the past, any sizeable market drawdowns may ultimately prove to be a buying opportunity for patient, long-term investors.

6. The benchmark 10-Year U.S. Treasury Note will increase from its current level of 1.45%.

As noted previously, we expect the Fed to be active in 2022, ending its quantitative easing program and raising short-term interest rates. Not coincidentally, the U.S. federal government still runs a massive budget deficit that must be financed with domestic and foreign capital. As fear slowly dissipates, investors will come to their senses and realize that a taxable yield of roughly 1.45% is unattractive in a world with mid-single digit (or higher) inflation. Hence, we think it is logical that the yield on the benchmark 10-Year Treasury Note will rise in 2022, especially once the global economic recovery takes hold in earnest.

7. International equities will outperform domestic ones, as the rest of the global economy plays "catch up" to the U.S.

U.S stocks, led by the mega cap Technology stocks, have had a great run over the past decade plus, compounding at 15% per year. These tremendous returns more recently have been driven in part by massive monetary and fiscal stimuli, as well as somewhat effective vaccination, pharmaceutical, and healthcare processes to battle COVID-19. In contrast, many other countries continue to grapple with vaccination rates below a quarter of their populations as well as lockdowns, greatly impacting economic activity. In our view, the rest of the world will gradually play "catch up" with the U.S. and their financial markets should benefit. In many instances, the valuations of foreign markets are more inexpensive than those in the U.S. and offer superior growth, providing a recipe for outperformance.

8. **Hedge funds, private equity, and liquid alternative assets will increase in aggregate as investors diversify from negative real bond yields.**

   How do you preserve or grow wealth when interest rates are well below the rate of inflation? We believe the answer to this riddle lies primarily in alternative investments, of both the liquid and illiquid variety. In our view, a portion of the record high amount of assets in demand deposits will find a new home outside the safe confines of FDIC insured accounts. The likely targets for these excess cash balances include the asset classes of hedge funds, private equity, infrastructure funds, and real estate. Furthermore, investors are slowly realizing that private equity investments are now permitted in some 401k plans, providing a secular tailwind of growth.

9. **Cryptocurrency assets will increase in the aggregate and Web 3.0 will proliferate.**

   It almost goes without saying that cryptocurrencies are controversial and extremely volatile. For example, most people find stock market volatility unsettling, but, by our estimates, Bitcoin is four times as volatile as the S&P 500. Nevertheless, the cryptocurrency universe, despite some froth, criminal behavior, and outright fraud is in the process of rewiring the global financial system. Some countries, such as El Salvador, are using it as legal tender, while in other instances they serve as a conduit for small firms to go public quickly. At Beacon, we currently do not have cryptocurrency assets formally on our platform. However, we do own shares in many Fintech firms that are at the center of the blockchain universe including PayPal, Mastercard, and Square/Block. Hence, there may be indirect ways to capitalize on the expected continued growth in the space, if you have the stomach for the volatility.

   Web 3.0, also known as Web3, is a term that combines the Internet with blockchain. Web 3.0 is decentralized, lowering costs and giving power back to the consumer. For example, if you have refinanced your mortgage in recent years you may have been annoyed by paying large title insurance fees. Title insurance assures the mortgage lender that you did not sell your home to anyone since your last purchase/refinancing date. If all title insurance was listed on the blockchain its contribution to the refinancing cost would likely be in the tens or hundreds of dollars, not thousands.

10. **The midterm congressional elections will result in a balance of power between Democrats and Republicans, informally known as "gridlock."**

    The November 2021 elections in the U.S., largely focused on gubernatorial races, may provide a clue that change will be in the air when the midterm congressional elections occur in November 2022. Currently the Democrats have control, in some cases by slim margins, of the Congressional and Presidential branches. In our view, it will lose its triumvirate status, relinquishing control of at least one of the Congressional branches, resulting in "gridlock." Financial market participants tend to favor a gridlock scenario since they often believe that the private sector is better at solving problems than the government, which usually has to raise taxes to fund expenditures.

Beacon's Four Strategic Wealth Management Themes for 2022

Investment forecasts in and of themselves are interesting, but of little direct value. They must be actionable if they are to be valuable for our clients. Therefore, coupled with our Ten Investment Forecasts we offer Four Strategic Wealth Management Themes for 2022, which are often tied to the specific investments in your portfolio.

1. **Temper return expectations after abnormally high recent performance.**

   As we have mentioned several times in this report, the performance of U.S. stocks over the past decade has been well above historical norms. Furthermore, other than occasional small drops, bonds have largely been in a bull market since the early 1980s. In our view, the tide is slowly turning, requiring a more thoughtful approach to deliver attractive returns than the conventional 60% Stock / 40% Bond portfolio. Fortunately, we at Beacon believe we are up to the task with our expansive menu of both in-house strategies and a lineup of diverse, value added third party managers.

2. **Seek alternatives to negative real bond yields amid a Federal Reserve tightening cycle.**

   Although we expect both short- and long-term interest rates to trend upwards in 2022 due to Fed policy, it may be quite a while before investment grade bond yields exceed inflation. The last time the Fed had a meaningful tightening cycle was in 2004, when the Federal Funds Rate rose from 1.0% to 5.25% over the course of roughly 2 years. Although we don't see such a dramatic surge in short-term interest rates in the current cycle, the Fed will almost certainly have to raise short-term interest rates if they seek to tame inflation.

   Historically, things have been more cheerful for municipal bonds, whose broad indexes achieved positive returns in 2022 and usually benefit from a steeper yield curve. We also favor fixed income in diversified portfolios to fund near term purchases and act as ballast during times of equity market distress. Nevertheless, we believe that investors in search of income need to get creative. Sources of income may include high dividend yield global stocks, Treasury Inflation Protected Securities (TIPS), infrastructure investments, real estate, and private equity/credit, despite the fact that some of these investments do not offer daily liquidity. Although they may have interest rate sensitivity, growth stocks that can raise prices usually also do reasonably well.

3. **Invest for a changing world order.**

   Since the end of the Cold War in the early 1990s the world order has been somewhat clear-cut. The U.S. has been the dominant leader, often in policy concert with its allies, amid a backdrop of increasing power for several emerging market nations – most notably China. China is now a full-fledged superpower and India is likely to follow given its demographics and current growth trajectory. Furthermore, the COVID-19 pandemic, supply chain crisis, growing government interventions in the economy, and a push towards clean energy (possibly to include nuclear power) have upended political and economic relationships that have been in place for decades. For example, many companies are now looking to diversify supply chains beyond China, and policies concerning climate change will strike at the heart of revenue generated by OPEC+ countries. These changes may lead to investment opportunities in companies that serve emerging market consumers, domestic contract manufacturing, clean energy, personalized medicine, hypersonic weapons systems, and a host of other investment opportunities.

4. **Ride the secular waves of technology, infrastructure, clean energy, and demographics.**

   Investing is a lot like running. It is easier if the wind is at your back. At Beacon we see several long-term secular trends in progress or unfolding. These trends include continued growth in the use of technology by global citizens and disruptive applications by businesses, the rebuilding of much of the world's infrastructure, the growth of clean energy and demand for minerals, and the aging of much of the world's population. Each of these trends has important investment implications that our managers at Beacon seek to capitalize upon for the benefit of our clients.

We at Beacon look forward to the opportunity to discuss our Ten Investment Forecasts with you, as well as the ways in which our Four Strategic Wealth Management Themes can be custom tailored to your personal situation. As always, we close by thanking you for your loyalty and support. We consider our relationship with our clients a true partnership, and our sole mission as a firm is to add value to our clients in any way we can. It is with the fulfillment of this mission in mind that each of us at Beacon is focused on individual and collective improvements each day. We also wish you a happy, and especially healthy, holiday season and a wonderful New Year.

Beacon Trust 163 Madison Avenue, Suite 600 | Morristown, NJ 07960 | 973.377.8090 | BeaconTrust.com