BERNSTEIN

Shifting Gears

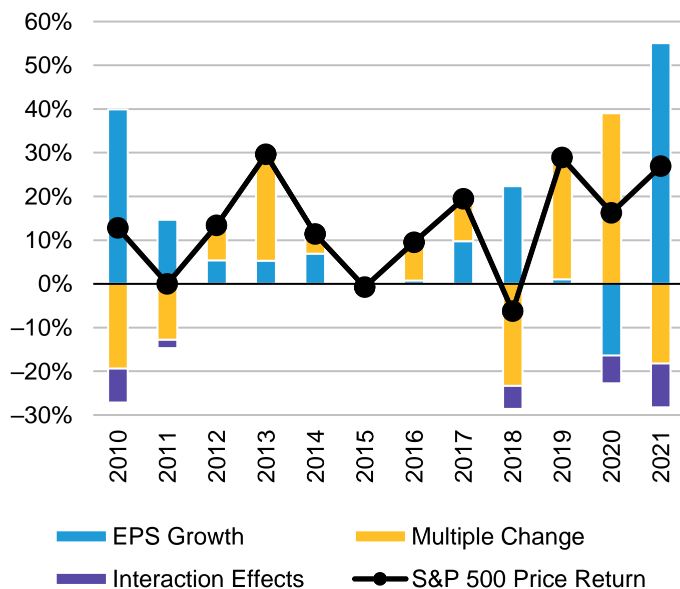
While life didn't completely normalize in 2021, it was certainly a better year than 2020 by most measures. In addition to one of the strongest economic rebounds in history, most asset classes performed well. And though new COVID strains emerged, the introduction of vaccines allowed many to rediscover what a normal life could look like.

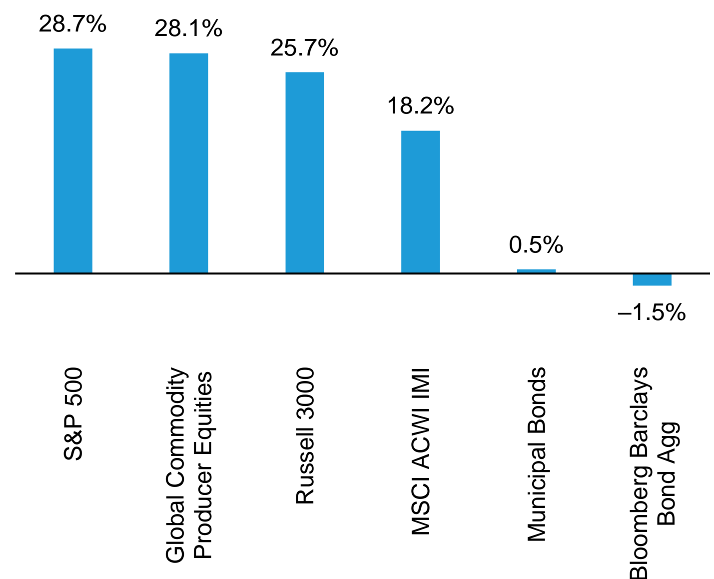
With the fourth quarter's data arriving later this month, we estimate US real GDP growth for the year coming in at a whopping 6.1%—the highest rate in almost four decades. Brisk economic activity, coupled with inflation, drove impressive gains in revenues. Ultimately, with margins rising, it is expected to result in S&P 500 earnings growth of 51%.

Asset prices also had a standout year. Large-cap US equities returned 29% and the global all-cap index returned 18%. Stocks of global commodity producers (often used as inflation protection assets) were up 28% and municipal bonds even scratched out 0.5% despite rising rates and risk appetite.

Of course, the pandemic remained an important area of focus for us this year, rivaled only by inflation. Year over year, the consumer price index rose around 7%, the Case-Shiller home price index was up 16%, rents +4%, used cars +31%, and WTI crude oil +55%. Yet despite this year's inflation spike, gold declined 4%, underscoring why we recommend a balanced inflation hedge rather than putting all your eggs in a golden basket.

DISPLAY 1: EARNINGS GROWTH UNDERPINNED STRONG ASSET PERFORMANCE





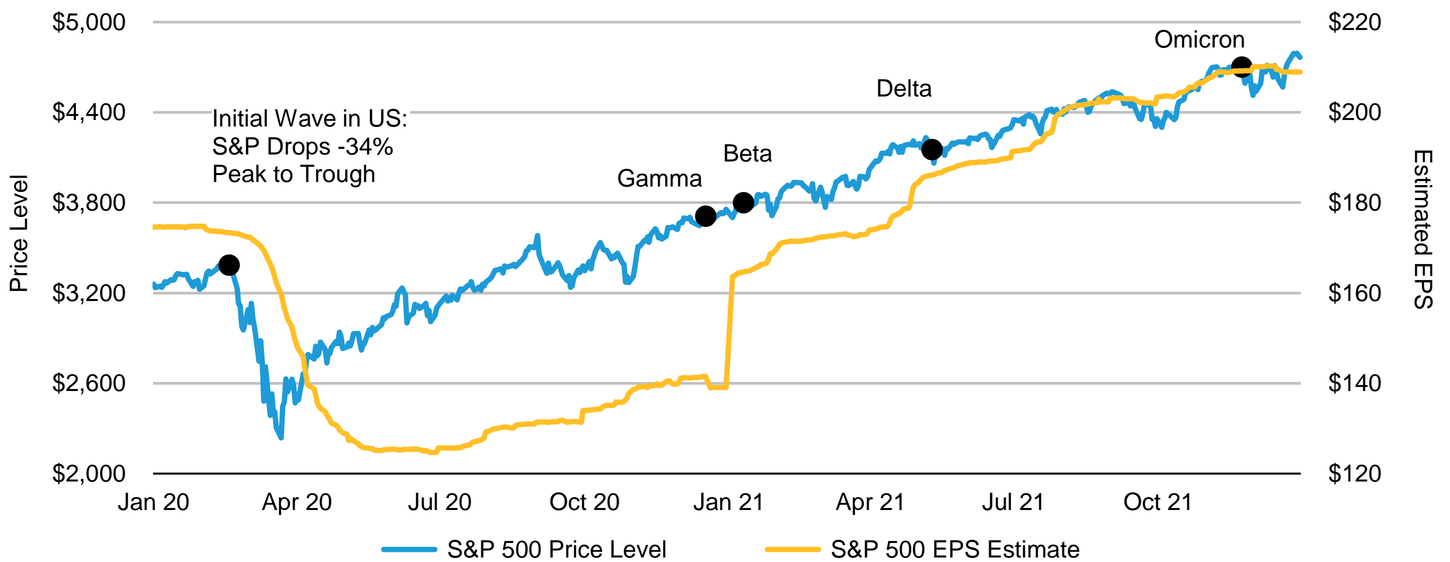
As of December 31, 2021. Chart on right shows total returns. **Historical analysis is not necessarily indicative of future results.**
Source: Bloomberg, FactSet, and AB

CORONAVIRUS: PANDEMIC VS. ENDEMIC

Entering 2021, the pandemic was in full force and we were looking forward to its impact waning as a global rollout of vaccines foreshadowed an economic rebound.

As we enter 2022, the pandemic unfortunately remains a factor, with the latest variant quickly overtaking the globe. We all learned more of the Greek alphabet, even discovering the correct pronunciation of "omicron." But even through the Delta and Omicron waves, the virus' ***economic and market*** effect has dwindled. COVID has claimed a staggering 5.5 million lives around the world and we remain indebted to the medical community for fighting through two years of COVID in stretched hospital systems. Yet amid this human tragedy, the markets have effectively shrugged off the news of each successive variant while focusing on corporate profits and consumer activity as leading drivers of market returns.

DISPLAY 2: COVID'S DECLINING IMPACT ON MARKETS AND PROFITS SINCE Q1 2020 OUTBREAK



As of December 31, 2021. **Historical analysis is not necessarily indicative of future results.**

Source: Bloomberg, WHO, and AB

As we look ahead to this time next year—barring the emergence of a more devastating variant—we expect (and hope!) that the coronavirus will become increasingly *endemic*, with vaccinations and treatments jointly reducing the morbidity and mortality of the disease. We believe this will allow the economy to generally withstand coronavirus-related shocks in the future.

Looking into 2022, we foresee the economy changing gears like a car—still moving forward but at a slower pace.

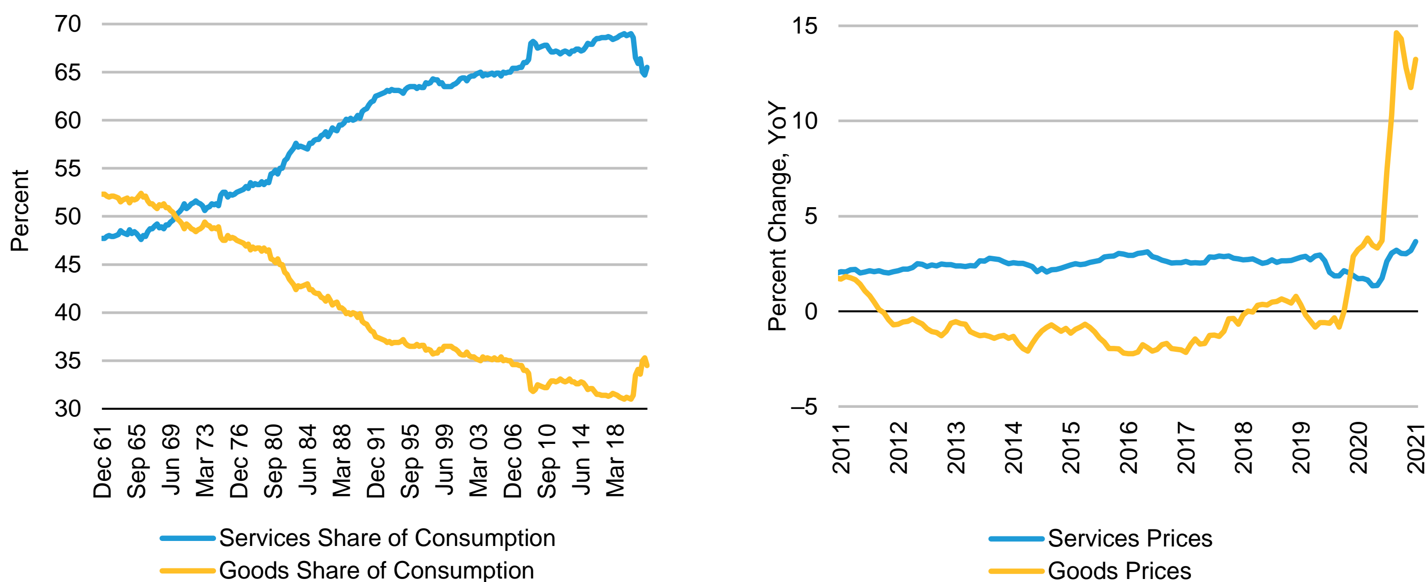
INFLATION: TRANSITORY VS. SECULAR

Coming into this year, we and others expected to see elevated inflation as the economy reopened and demand outstripped supply. Yet the market missed the extent to which durable goods production would be limited by a constrained supply of computer chips and the chaos that would be unleashed by an out-of-sync shipping industry. From January through July, an average of 23 containerships floated off the coast of Los Angeles. By mid-November, that figure had risen to 83.

Clearly, this year's 7% inflation has come in stronger and lasted longer than we, the Fed, and most investors anticipated. In the spirit of *The Christmas Carol*, we think it's safe to say that the Fed's original term, "transitory," is now "dead as a doornail," replaced by the watchword "persistent." Yet we still don't view this as the beginning of a secular wave that keeps inflation at these lofty levels.

What's driven this flare-up? The demand for goods is running $500 billion, or 10%, above its long-term trend while services demand is down by the same amount. Meanwhile, the supply of goods has been hampered by semiconductor shortages, shipping delays, and difficulties hiring despite elevated unemployment. Gasoline prices have also risen with resurgent demand and greater discipline by the industry when it comes to production (a welcome change for those who held shares in oil and gas companies over the past decade).

DISPLAY 3: A DEMAND SHIFT FROM SERVICES TO GOODS HAS DRIVEN INFLATION



Source: Haver Analytics, BEA, BLS, and AB

Over the course of 2022, we expect demand to gradually shift back toward services as people regain confidence in mobility. That part of the economy operates further below its capacity constraints than the goods side, so it should better absorb demand. The temporary constraints from chip shortages and shipping woes should also begin to ease. We do anticipate further tightening in the labor market in 2022 as hiring accelerates. And we expect shelter costs to be a persistent driver of inflation. But with the improving supply and demand picture, a $1.5 trillion year-over-year decline in fiscal stimulus, the Fed embarking on a rate-hiking cycle, and inflation expectations remaining well anchored, our US economics research team foresees inflation falling to less worrisome levels as the year unfolds.

That said, we continue to refer inflation-minded investors to our research, published in the heart of this summer's inflation spike, for our recommended approach. Please connect with your Bernstein financial advisor on the suitability of inflation-linked portfolios or alternative income strategies based on your assets, spending needs, risk, and liquidity profile.

WHERE TO FROM HERE?

In 2022, we anticipate that the US and global economy will continue to grow at an above-trend rate. That should generally be good for businesses, consumers, and governments, while supporting asset values.

As you frequently hear us say, we recommend a diversified approach to investing, but some areas look more attractive than others. With the economy expanding and rates rising, we favor a reasonable degree of credit risk in the fixed income space—whether in municipal, corporate, or other bonds. We're already tilting our portfolios in this fashion. Given rising rates, we also prefer floating-rate debt including private corporate credit, real estate debt, and securitized assets.

Despite potential pressure on earnings multiples from rising interest rates, we believe the earnings environment and risk appetite are likely to prove favorable for equities. After a year in which margins rose broadly in an inflationary environment, a critical dividing line is likely to emerge next year. The market may reward companies that can sustain high margins in the face of cost pressures and punish those who run into the limits of their industries. Given the inflationary backdrop, equities with pricing power remain an attractive hedge. Furthermore, the recent high degree of dispersion in stock returns suggests a relatively attractive opportunity for stock-picking as winners distance themselves from losers in this environment.

We continue to focus on strategies that can deliver in areas other than the equity market without sacrificing returns—for instance, hedge funds, private equity, and special situations. Our selection of Purpose Driven strategies also continues to grow as many investors want to simultaneously "do good and do well." In 2022, we'll add to our portfolio offerings that combine alternative asset classes and Purpose Driven strategies.

Finally, for inflation-sensitive clients, we continue to recommend a balanced approach to protect against the more pernicious effects. This consists of inflation-protected bonds, stocks with pricing power, commodity futures and commodity stocks, along with real estate.

Alex Chaloff

Beata Kirr

Alex Chaloff and Beata Kirr are co-heads of the Investment Strategy team at Bernstein, a group of senior investment professionals who develop our investment advice and are responsible for investment outcomes. The team oversees Bernstein's investment offerings, ensuring that our asset allocation advice, suite of strategies, and development of new investment ideas are continuously focused on moving our clients forward with strong after-tax risk-adjusted returns. Both Alex and Beata have spent their Bernstein careers refining our investment platform, listening to clients, and conducting deep research into investment topics that are critical to achieving clients' goals.

The Big Picture *aims to pull back the lens and reflect on some personal high level observations.*

Debt: Propellant vs. Explosive

Alex: *The last time interest rates remained artificially low for a prolonged period, we ended up with the housing crisis in the US that kicked off the Global Financial Crisis. Well, interest rates have been artificially low for a long time. What new distortions have been created in corporate debt, margin debt, and government debt?*

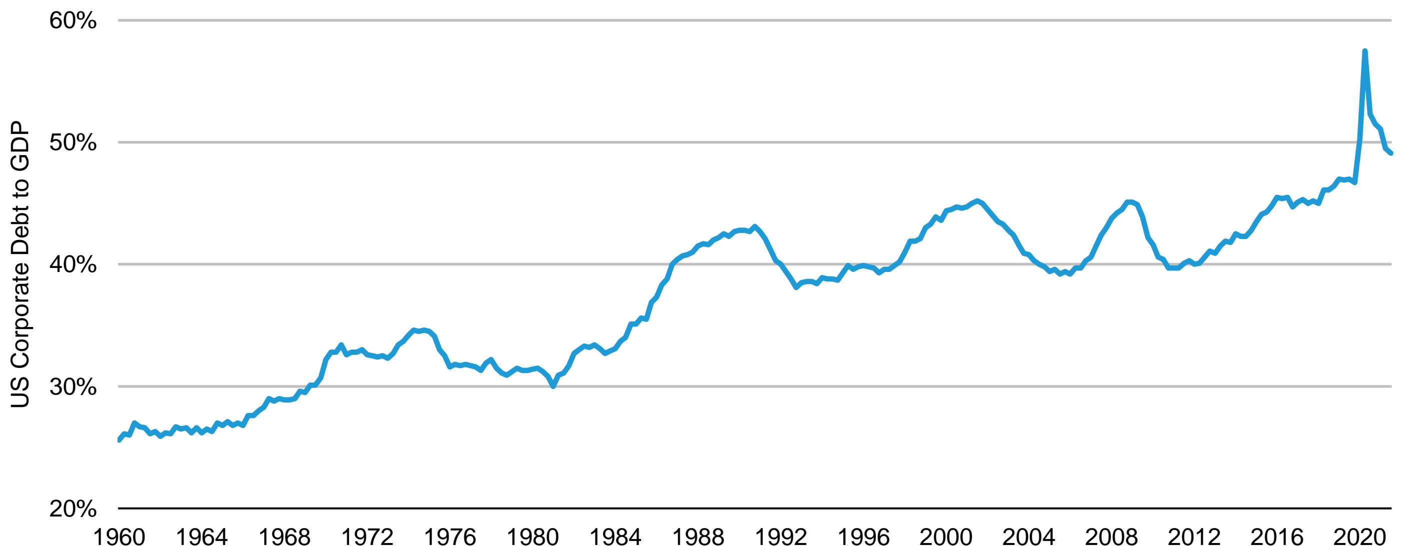
Due to the surge in corporate debt that sustained US companies through the pandemic, and even with the rebound in GDP, the ratio of corporate debt to GDP is at its highest level in history. That is manageable for the time being, with interest rates near record lows and maturities staggered in the coming years. But it could become an issue over time as the Fed hikes interest rates and those debt balances must be rolled over or paid down. The ticking clock for rate hikes has finally rung the alarm. The Fed has signaled that higher rates are coming this year. As rates rise, the high level of corporate debt could create fragility in the economy, lead to lower investment and growth, and/or result in government policy that produces zombie firms whose earnings persistently fall short of interest payments, with only further debt issuance to support them.

With the amount of speculation in some parts of the equity and crypto markets, we're also keeping an eye on margin debt and its equivalents. Leverage can be used judiciously to enhance returns, but it can also lead to cascades of forced selling and collapsing markets. We're monitoring margin balances in the stock markets and have been struck by the accounts of levered positions in the even-more-volatile crypto markets. Borrowing against one's equity portfolio is nothing new. Borrowing against a crypto portfolio is something entirely new.

In response to the pandemic, government debts have risen sharply. For emerging and frontier market economies, this poses acute challenges, leading to a trade-off between inflation and higher interest rates which limit economic growth. Developed market economies like the US are in a better position, but even here, we face the same challenge but to a less limiting degree.

In 2008, there were many learnings of "should'a and could'a." In this cycle, we are keenly aware not only of the risks we are taking but of the risks that others are taking, too.

DISPLAY 5: US CORPORATE DEBT HAS REACHED HISTORICALLY HIGH LEVELS



Source: Federal Reserve Board, Haver Analytics, and AB

Climate: Risk vs. Opportunity

Beata: *With COP26 front and center, this past quarter brought a year's worth of shocking weather headlines into perspective. Our Responsible Investing colleagues opined on their conclusions here. There is much to be done for the world to make good on the commitments agreed to in Glasgow and much for us to process in terms of what we already experienced in 2021.*

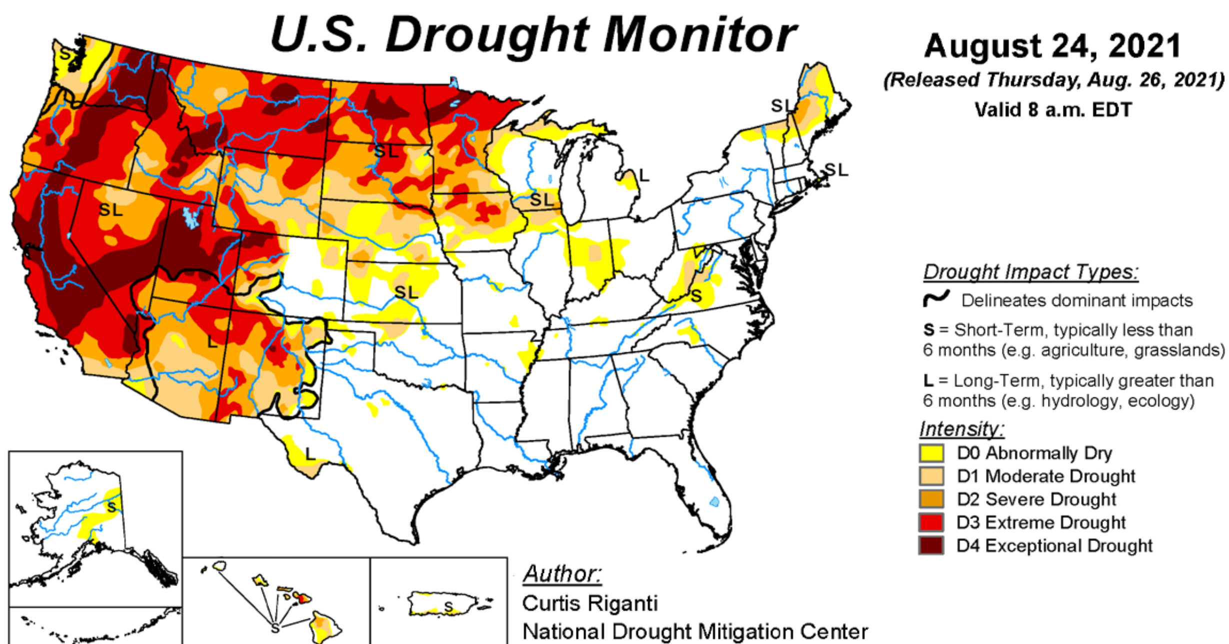
For instance, this year in the US, we saw a Texas freeze in February, Hurricane Ida in late August and early September, and months of California wildfires that caused billions of dollars of direct damage while disrupting energy and other markets across the country. Outside the US, floods wreaked havoc in Europe and Siberia experienced wildfires larger than all other fires in the world combined, sending smoke to the North Pole for the first time in recorded history. In the Amazon, fires burned over 260,000 acres of land, the equivalent of all of Los Angeles, despite a ban on unauthorized outdoor fires in Brazil.

With future warming and weather volatility already baked in from existing greenhouse gases (GHGs), the scope for disruption remains significant. From lost property values to food inflation, the economic consequences are incalculable. Some companies will find their business models at risk. Yet the flip side of risk is opportunity. There are many ways companies can deliver value to customers and investors by addressing these challenges.

Companies that think about climate now—and put money toward solutions—will be better prepared to face the future in a market where competitors may develop lower carbon alternatives. We have spent much time in our investment teams understanding the implications of climate change and formed our thoughts on the net zero journey.

Inside our growing roster of Purpose Driven strategies, we're actively discerning between the companies for which this serves as a tailwind and vice versa. We also have a partnership with Columbia University's Earth Institute to better understand the impacts of climate change on the economy and markets. The markets are starting to incorporate the long-term consequences in the shorter term, and new technologies are increasingly emerging in the public markets as potential solutions. Perhaps most excitingly, in certain strategies, we're investing in the innovators bringing climate solutions to market and taking short positions in companies poised to be disrupted by these changes. Please connect with your advisor if you are interested in learning more on this topic.

DISPLAY 4: CLIMATE RISKS CREATE CHALLENGES FOR BUSINESSES AND SUPPLY CHAINS



Note: The U.S. Drought Monitor is jointly produced by the National Drought Mitigation Center at the University of Nebraska-Lincoln, the United States Department of Agriculture, and the National Oceanic and Atmospheric Administration. Map courtesy of NDMC.

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