Market Strategy
by STRATEGAS A BAIRD COMPANY

BAIRD
Private Wealth Management

Major Investment Themes for 2022

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We believe these six key items will be major investment themes for 2022: 1) inflation and the Fed's response 2) higher interest rates hurting high growth stocks, 3) rising geopolitical stakes, 4) tighter financial regulation, 5) dividends as a greater portion of total return, and 6) the de-conglomeration of big Tech. We dive into each in detail below.

THEME #1: INFLATION AND THE FED AS MAJOR ISSUES IN THE MIDTERM ELECTIONS

For those of a certain age or with an interest in economic history, it would be difficult to overestimate the importance of price stability when forecasting the performance of financial assets. Nearly two generations have reaped the reward of either declining inflation or outright price stability, while many have likely forgotten the ravages of inflation that led BusinessWeek to announce the "Death of Equities" in an August 1979 cover story and left the S&P 500 trading at less than 7x earnings with a 6% dividend yield by August 1982. **The inflationary period between 1968 and 1982 was home to great economic volatility and four distinct recessions.**

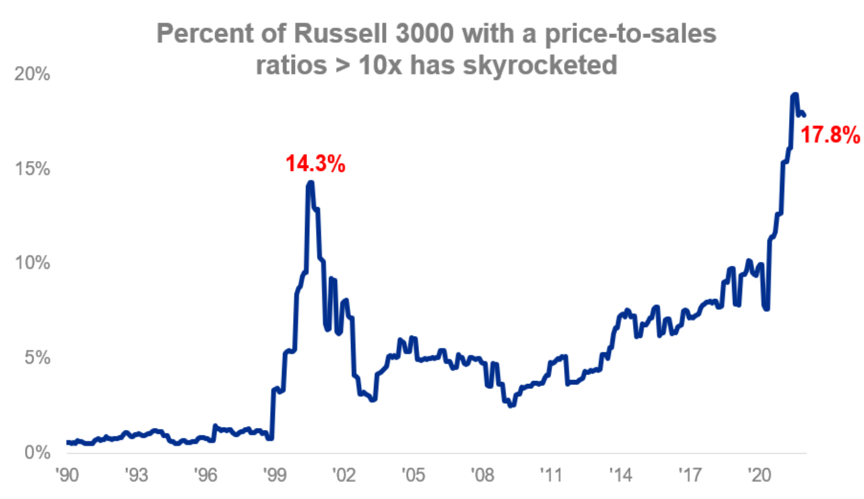
We believe the current debate over inflation is often being framed as a false choice between the double-digit inflation of the 1970s versus an entirely "transitory" episode. While some supply-chain issues will undoubtedly ease, we believe that inflation will be more structural, particularly around rents and wages. Further, the environmental movement (and the scarcity of investment in drilling and mining that should result from it) will, in our view, only fortify the upward price movements in oil and commodities, especially in those necessary to produce electric vehicles.

Given that the Fed has been exclusively focused on full employment since the start of the pandemic, stickier inflation presents a challenge for the central bank (particularly given the sensitivity of financial assets to increases in long-term interest rates). Though the Fed has recently pivoted hawkish and signaled a willingness to battle inflation, they are still easing and their balance sheet remains twice as large as it was pre-pandemic. For the first time in 40 years, inflation and the Fed's ability to deal with it will be on the ballot next November.

THEME #2: PRICE-TO-SALES CEASES TO BE A VALID VALUATION TOOL

An incredible 18% of companies in the Russell 3000 are currently trading at 10x price-to-sales or higher. If we are correct in our belief that an end to Fed purchases of Treasurys and sticky inflation will lead to higher-than-expected long-term interest rates, it seems reasonable to expect that the highest duration companies (i.e. high growth firms whose current value is most derived from potential cash flows in the distant future) will suffer the most. There were bouts of such thinking in 2021, but, in the end, bond yields never topped the 1.77% they reached last March.

The efficacy of this theme will be driven by the persistence of higher inflationary expectations and higher long-term interest rates.



THEME #3: A TEST OF WESTERN GEOPOLITICAL RESOLVE

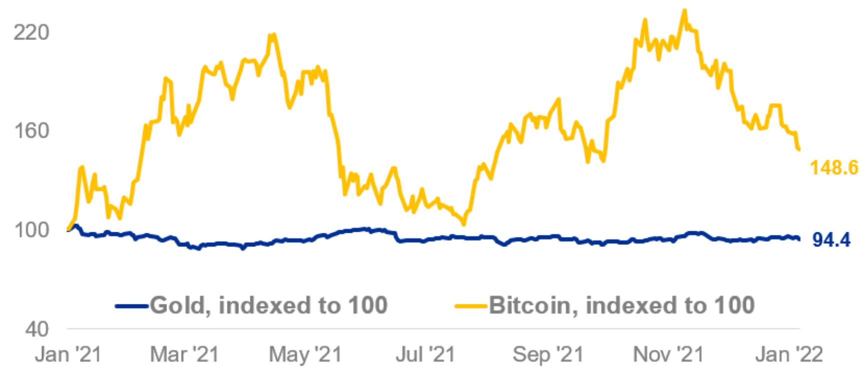
We claim no expertise in the fields of foreign affairs or national security issues here at Strategas, but we also find it difficult to ignore the increasingly confrontational nature of both Russia's and China's relationship with countries espousing Western values. Whether one believes President Trump's tactics regarding China were effective, we think that popular opinion has changed regarding our trading relationship with China and their future geopolitical ambitions. The country's initial handling of the Covid-19 crisis, its treatment of ethnic minorities, and its increasingly aggressive actions in Hong Kong have—by our reading—further eroded popular opinion and sowed skepticism about the Chinese Communist Party's long-term motives.

Further, Russia's continued threats of acting on territorial ambitions in the Ukraine and its willingness to use its vast resources of oil as leverage to pursue its national security interests are yet another reminder that not all peoples strive to be "citizens of the world." At the same time, political and social issues at home may entice our rivals to test our geopolitical resolve. **This, combined with concerns about the robustness of our supply chains, is likely to, at the very least, slow down the path to globalization and the disinflation that has been associated with it.** Populist tendencies in the West are likely to persist.

THEME #4: TIGHTER FINANCIAL REGULATION, ESPECIALLY ON CRYPTO

We continue to see increasing client interest in cryptocurrencies. We think a key 2022 theme will be the way Bitcoin and other blockchain-linked financial products are regulated. We have no doubt that cryptocurrencies are here to stay, but we remain skeptical that governments in developed economies will give up their monopolies on fiat money. The wisdom of investing in such products will be linked to the appetite of governments to regulate them. More generally, we think it's a decent bet that SEC Commissioner Gary Gensler will become a more muscular presence on the investment landscape in 2022.

Bitcoin highly volatile, but has outperformed Gold over last year



Elsewhere, as highlighted by our Washington team, the departure of Randall Quarles as Vice Chairman for regulation at the Fed will likely lead to greater financial regulation of the banks in 2022. Greater capital requirements and bank stress tests that focus on the effects of climate change seem likely. We remain overweight the Financials sector based on the belief that a steepening yield curve will be more important than tighter financial regulations in the end. Still, our head is on a swivel.

THEME #5: DIVIDENDS AS A GREATER PORTION OF TOTAL RETURN

Highly related to our call for single-digit returns in 2022. This forecast has become consensus not necessarily because of expectations about earnings (we are forecasting a ~9% increase from 2021), but rather because of fears about the multiple investors will be willing to pay for those earnings this year. It's difficult to forecast expanding multiples for a year in which the Fed will be tightening. Of course, it's not uncommon to see a blow-off top in the markets as interest rates are rising. In 1987, the S&P 500 went up roughly 40% from January through August as the 10-year Treasury yield rose. Rates would eventually need to peak at roughly 10.3% in October to quell the stock market advance. Similarly, in 1999, the NASDAQ increased by 85% as long rates rose from 4.7% to 6.4% and the Fed hiked three times. Such advances are possible this year, but it's difficult to make it our base case.

Dividend Contribution to Total Return

Decade	Price Return	Dividend Contribution	Total Return	Dividends as a % of Total Return
1930s	-41.9%	56.0%	14.1%	100.0
1940s	34.5%	100.1%	134.6%	74.4
1950s	257.3%	180.3%	437.7%	41.2
1960s	53.7%	54.2%	107.9%	50.2
1970s	17.2%	59.1%	76.4%	77.4
1980s	227.4%	143.1%	370.5%	38.6
1990s	315.7%	115.7%	431.5%	26.8
2000s	-24.1%	15.0%	-9.1%	100.0
2010s	189.7%	66.9%	256.7%	26.1
Average	**114.4%**	**87.8%**	**202.2%**	**59.4**

We also believe it's important to remember that dividends have made up ~60% of the S&P 500 total return (on average) each decade since 1930, even though share repurchases have largely replaced them as a tool to return money to shareholders. We believe that the potential for lower returns and higher inflation will render shorter duration equities with high yields more attractive in the years come. It should be remembered that, despite its outperformance last year, the S&P Energy Sector still sports a greater than 4% yield.

THEME #6 (LONGSHOT THEME): THE DE-CONGLOMERATION OF TECH

It might be hard to believe today, but there was a time in American business history when the idea of a conglomerate was a relatively new and exciting prospect. The manufacturing-oriented nature of the postwar American economy meant that it wasn't uncommon to see (relatively mild) recessions every four or five years. The "solution" was to smooth out the business cycle by housing under one corporate roof a portfolio of companies that sold everything from nuclear weapons to "I'm With Stupid" t-shirts.

Volatile stock prices, persistently low interest rates, and the Celler-Kefauver Act of 1950 (which made it more difficult to grow through vertical and horizontal integration) provided the impetus for the conglomerate boom in the 1960s. The eventual Achilles' Heel of this model was, predictably, higher inflation and interest rates.

While the few remaining conglomerates of yore like General Electric, Siemens, and United Technologies have sought to get smaller recently, new conglomerates like Amazon and Facebook (Meta) seem to be going the other way. These firms use a cheap cost of capital to expand into businesses that can take advantage of their "platform" and network effects, (e.g. self-driving automobiles and EVs). This feature of the new tech sector conglomerates may make them more durable than their predecessors, but we believe that a combination of stronger regulation and a higher cost of capital may lead both management and investors to conclude that the companies are worth more broken up than as single entities. One hopes this decision is made while valuations are still rich and not after inflation and interest rates force the issue.

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