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Hightower Investment Solutions: 2021 Market Recap and 2022 Outlook

From Rotation to Inflation
… and The Fed

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2021 Was "The Year of the Rotation"

In 2021 investors transitioned between growth and value, as risk-on and risk-off sentiments shifted with periods of re-opening, "peak growth" headlines, COVID fears, robust demand and Fed policy uncertainty. The markets rewarded discipline and conviction in attractive valuation, quality balance sheets and secular growth opportunities.

2021 Was "The Year of the Rotation"

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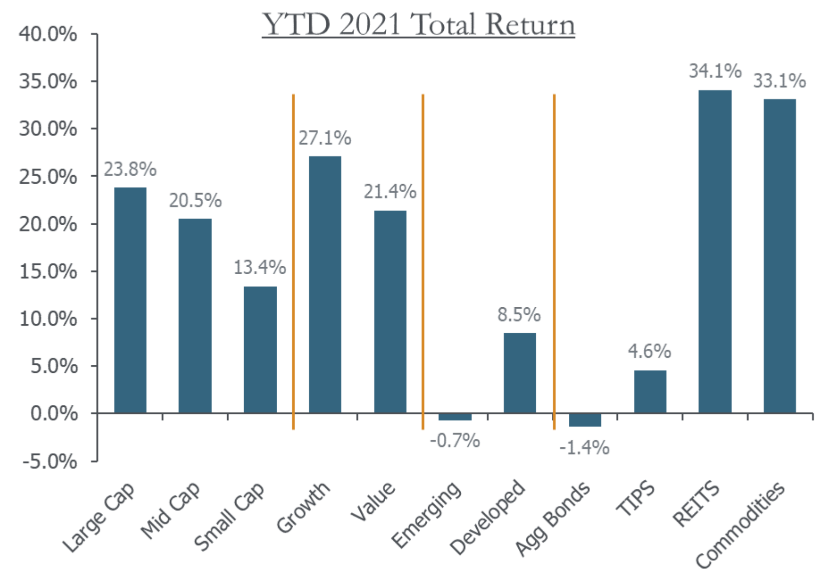
In 2022, we anticipate elevated inflation, less stimulus and a tighter Fed policy. Through H1, we believe growth will be above-trend, but at a slower rate compared to 2021. Stronger labor markets and continued wage increases should improve consumer spending.

Growth/Value Rotation By Month

	S&P 500 Value	S&P 500 Growth	
Total	**21.08**	**27.87**	
January	-1.57	-0.48	
February	5.89	-0.00	Pent-up demand post-vaccine rollout
March	6.27	2.65	
April	3.73	6.87	
May	2.41	-0.89	
June	-1.17	5.68	
July	0.76	3.75	"peak growth"
August	1.72	4.19	
September	-3.28	-5.80	Delta-variant
October	4.59	9.08	
November	-3.25	1.42	Fed shifts hawkish
December (through 12/17)	3.78	-0.72	

Source: FactSet (chart)

Asset Class Performance in 2021



Source: FactSet (chart)

Commodities and Real Estate were the best performing asset classes in 2021, driven by supply shortages and elevated demand.

Robust Consumer Demand Should Continue

Throughout the economic recovery the consumer has been resilient, boosted by fiscal and monetary policy support and the pandemic's impact on elevated excess savings and pent-up demand.

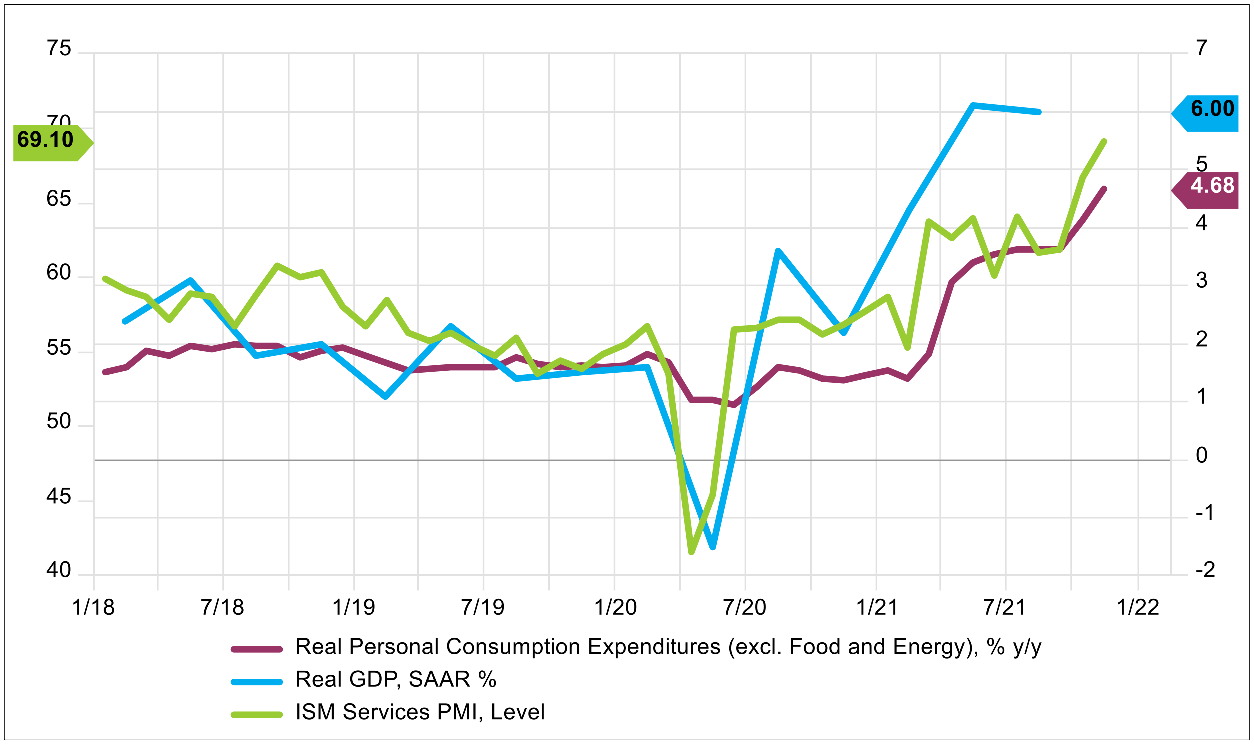
We expect real GDP for 2021 to be above trend, and further believe it probably would be higher if not for the significant supply chain challenges businesses have had to overcome to service robust demand.

Robust Consumer Demand Should Continue

ISM Services shows business activity, new orders and backlogs (leading indicators) continuing to expand. New orders are a leading indicator of earnings, and future capex intentions are at record highs – which we see as good news for growth, as services represent nearly 70% of GDP. In addition, manufacturing is having a renaissance with strong demand, lean inventories and pricing power.

Higher rates of personal consumption indicate that consumers maintain liquidity and they're spending on goods and services, driven by pent-up demand. Stronger labor markets and continued wage increases should improve consumer spending.

Business Activity Continues to Expand



Source: FactSet (chart)

Robust Consumer Demand Should Continue

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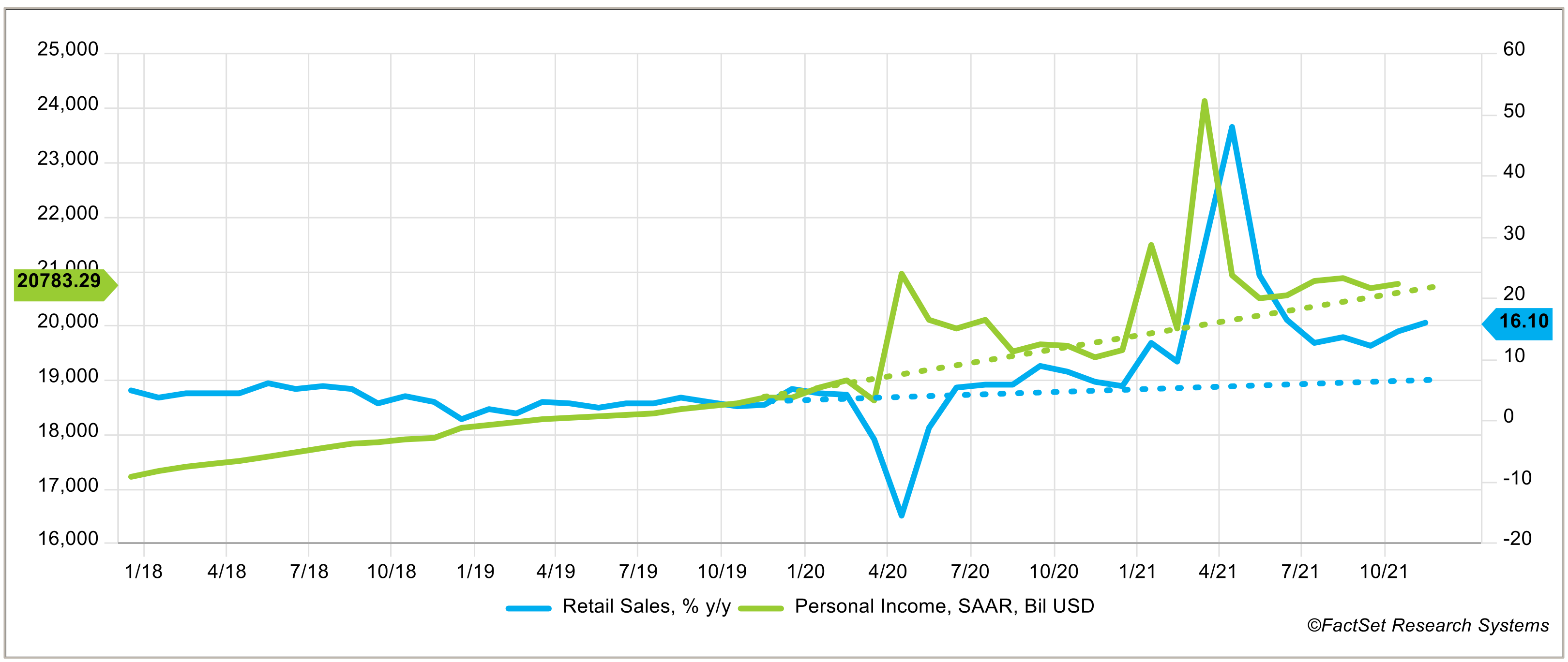
Retail sales are +16% above pre-pandemic levels, with strong consumer demand fueled by higher personal income and elevated savings.

Retail sales in 2021 have been driven by investments into homes (due to higher property values) and do-it-yourself trends. Investments toward omnichannel services also contribute to higher sales.

Retail Sales and Personal Income Continue to Grow



Inflation Has Accelerated to Rates Not Seen in Decades

CPI started the year +1.4% y/y and November hit +6.8% y/y. Core CPI (excluding food and energy) started the year +1.6% y/y and in November hit +4.9% y/y.

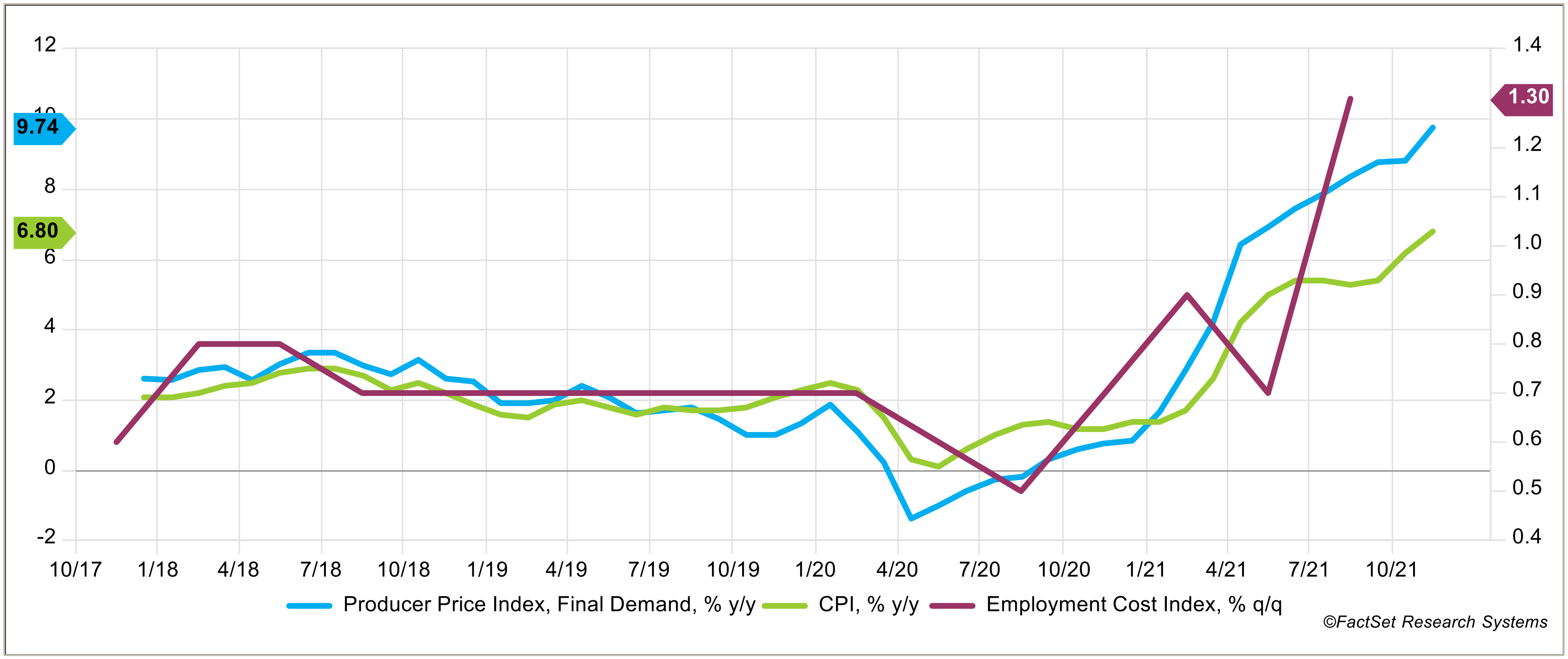
We believe the stickier components (e.g., rents and wages) will keep upward pressure on inflation – albeit probably lower than current levels.

We see inflation as above trend; not runaway but enough to expect the Fed to move with its taper and higher Fed Fund rates throughout 2022.

Inflation Has Accelerated to Rates Not Seen in Decades

Soaring producer prices reflect higher business costs. Higher costs are broad-based and include energy, transportation and warehousing, construction and food.

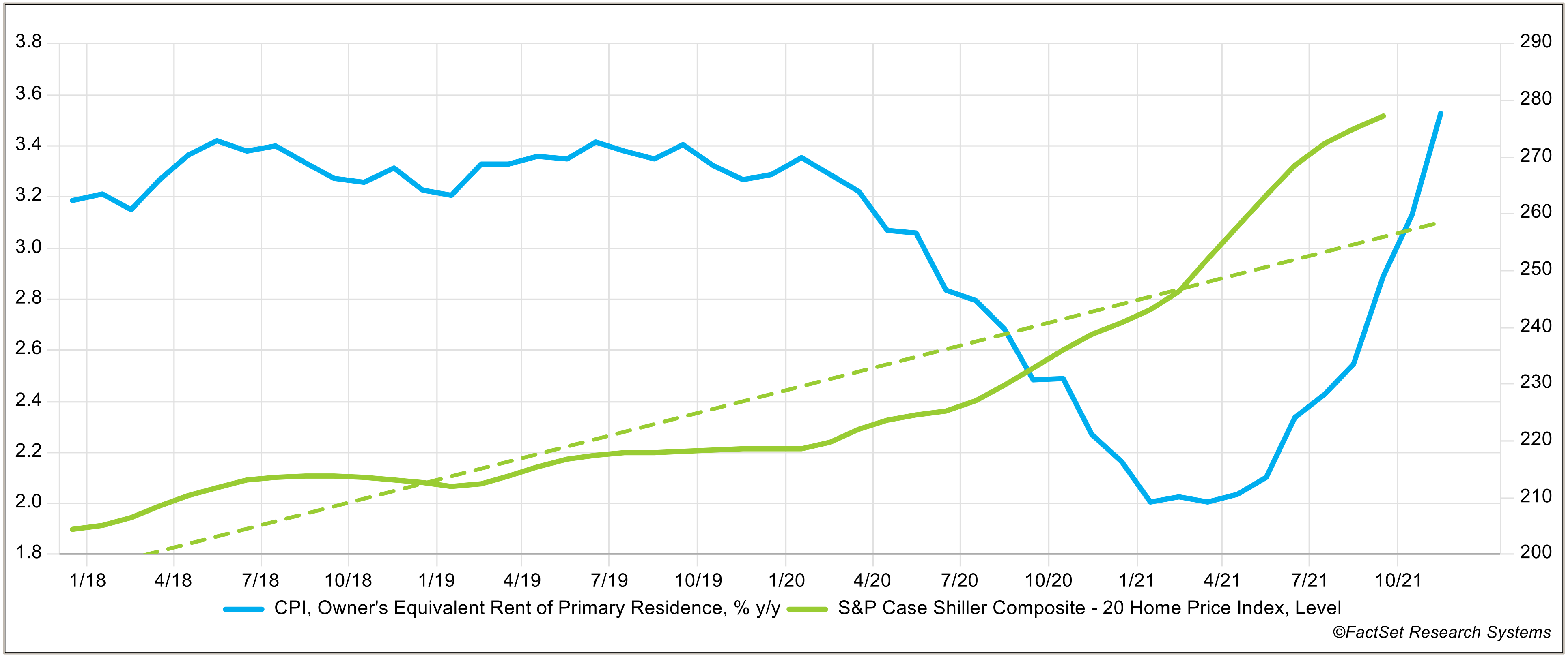
Producer Prices, Consumer Prices and Wages Are Rising



Inflation Has Accelerated to Rates Not Seen in Decades

- Housing prices have risen more than +19% y/y.
- Limited supply of homes and high prices have led to more significant rental demand.
- Rental costs, which tend to follow housing costs and are typically a significant and sticky component to inflation, are also soaring. Rents have already grown +20% y/y in parts of the country.

Upward Pressure on Housing Prices and Rental Costs



Demand For Labor is High – in a Tight Labor Market

In the face of robust consumer demand, companies have had to compete for additional labor capacity. Unemployment continues to move lower (4.2% in November) because jobs are plentiful (there are over 11 million job openings as of October), and wages are rising.

Demand For Labor is High – in a Tight Labor Market

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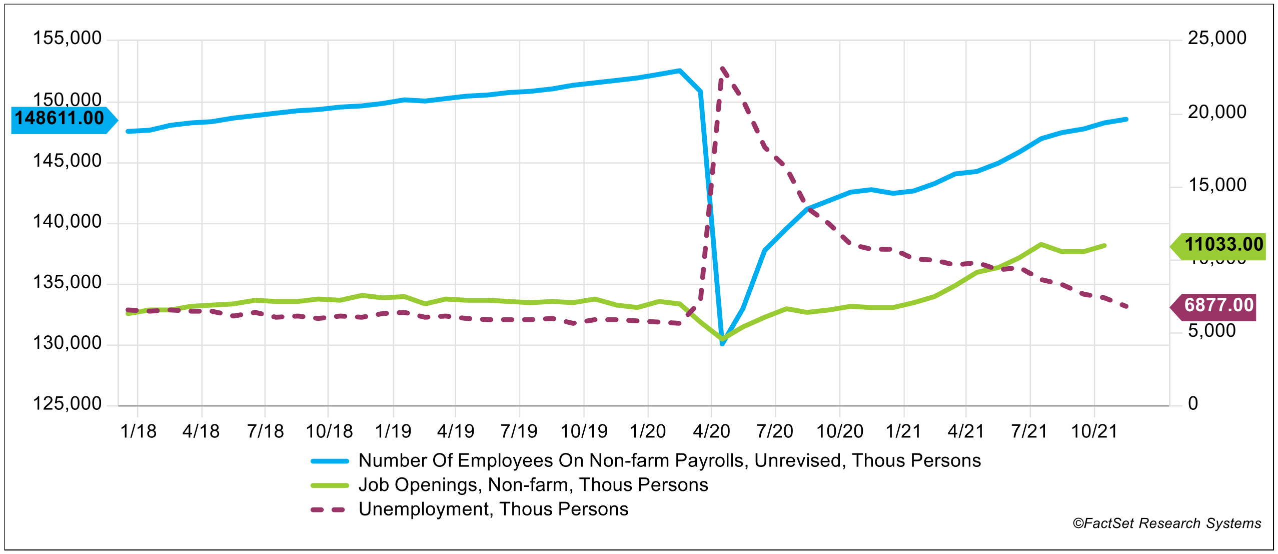
Abundance of job openings has contributed to declining initial claims for unemployment throughout 2021. Quit rates have also risen as employees use leverage to gain more attractive jobs.

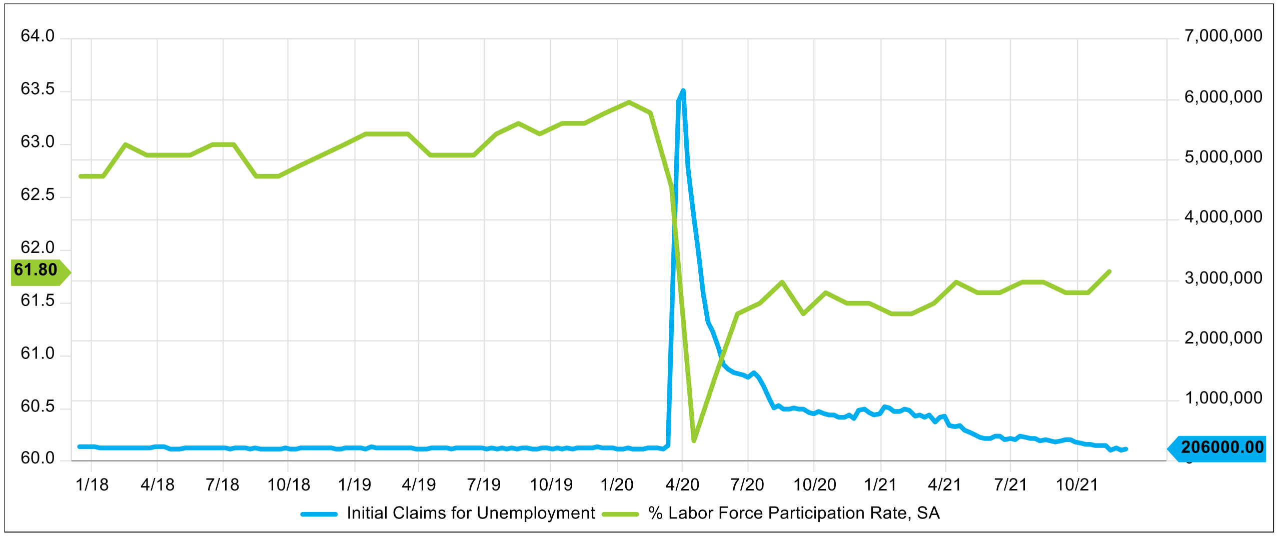
The labor force – measured by labor participation rate – has not returned to its pre-pandemic level, contributing to tight labor markets. Lower participation can be attributed to continued labor impacts from COVID-19 and elevated savings/stimulus.

A smaller pool of applicants has driven companies to offer higher wages, leading to a stronger consumer, but also higher inflation.

Payrolls and Job Openings Increase; Unemployment Falls



Labor Participation Remains Lower Than Pre-Pandemic



Source: FactSet (chart)

Productivity Slowed While Labor Costs Soared

Productivity, measured as the output per hour of work, slowed in Q3. Higher labor costs, tight labor markets and supply chain challenges all contributed to the lower productivity – but we expect to recover somewhat in 2022.

Productivity Slowed While Labor Costs Soared

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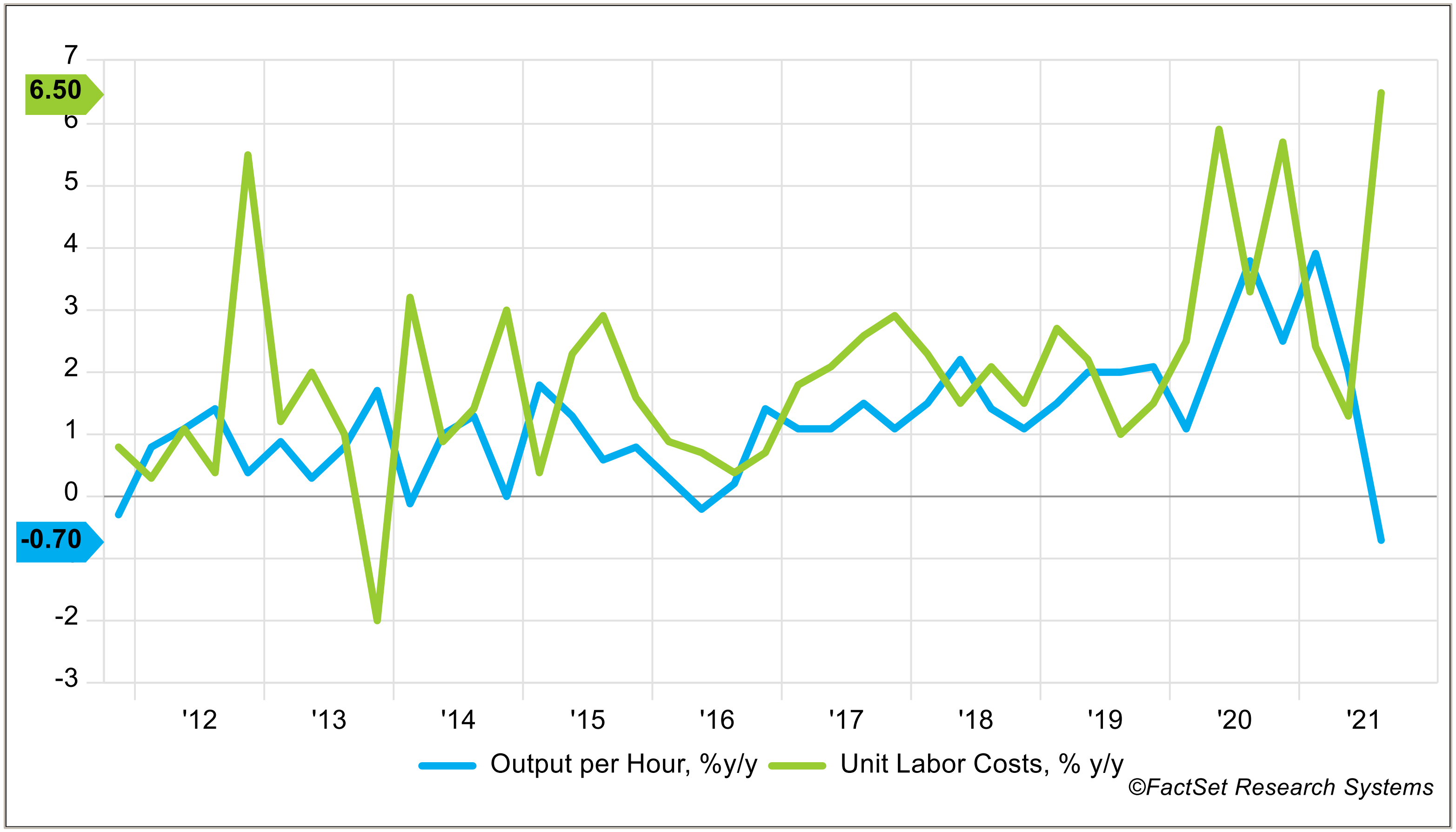
- Q3 unit labor costs reached its highest y/y increase since 1982, reflecting the limited capacity and inflationary cost pressures that businesses are experiencing in their effort to meet demand.
- Progress towards full employment and investments into new capacity will support better productivity, which should help to slow the rate of inflation.

Quarterly Productivity Down, Labor Costs Up



Supply Chain Challenges Continue

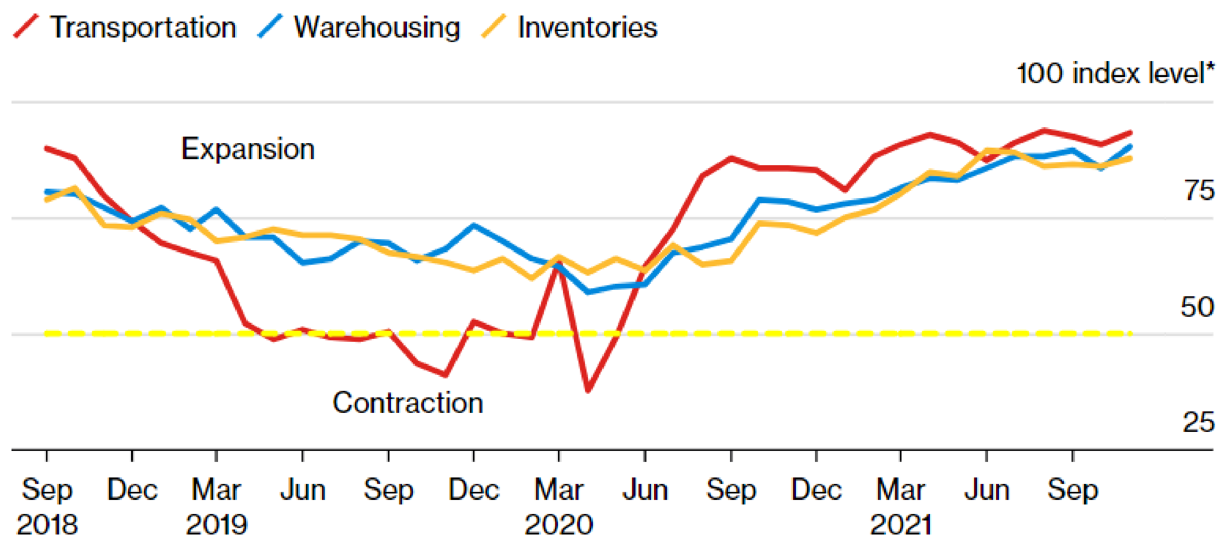
We anticipate continued supply chain disruption-driven shortages in 2022. While we expect improvement, we are watching the data carefully.

Supply Chain Challenges Continue

Examples of current shortages we expect may continue and contribute to price pressures include:

- Truck and chassis shortages at ports
- Labor demand
- Lithium
- Semi-conductors
- Energy/Fuel
- Fertilizer
- Lumber

Transportation, Warehousing, Inventory Costs all Expanding[1]



* The Logistics' Managers' Index is a diffusion index where 50 is the dividing line between expansion and contraction. Survey respondents, in November, did not anticipate any significant relief in costs over the next twelve months.

Consequently, we'll be watching for:

- Potential disruption from union labor negotiations at ports
- Impacts from a more permanent shift of peak demand seasons - businesses shifting preference towards excess inventories
- Shipments of automobiles taking up new capacity

[1] Source: Logistics' Managers' Index, Bloomberg (chart)

Fed Normalizing: Tapering with Potential for 2022 Rate Hikes

The Fed is on a path towards normalization, and the key driver of future expected rate hikes will be inflation.

Fed Normalizing: Tapering with Potential for 2022 Rate Hikes

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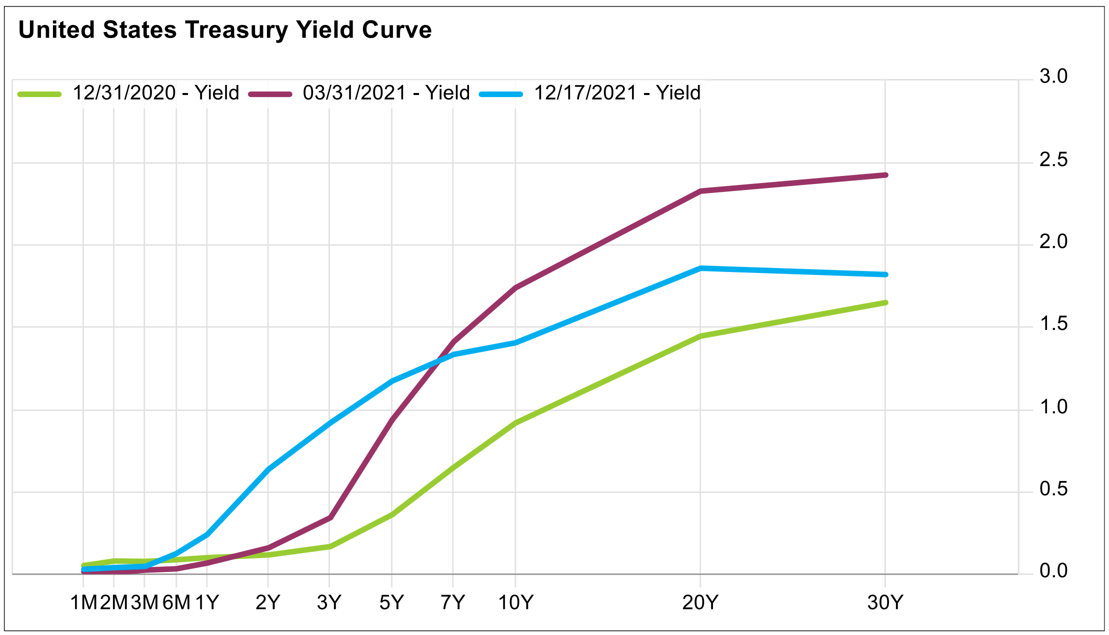
Short Term Yields Have Risen, but the Yield Curve has Flattened



Source: FactSet (chart)

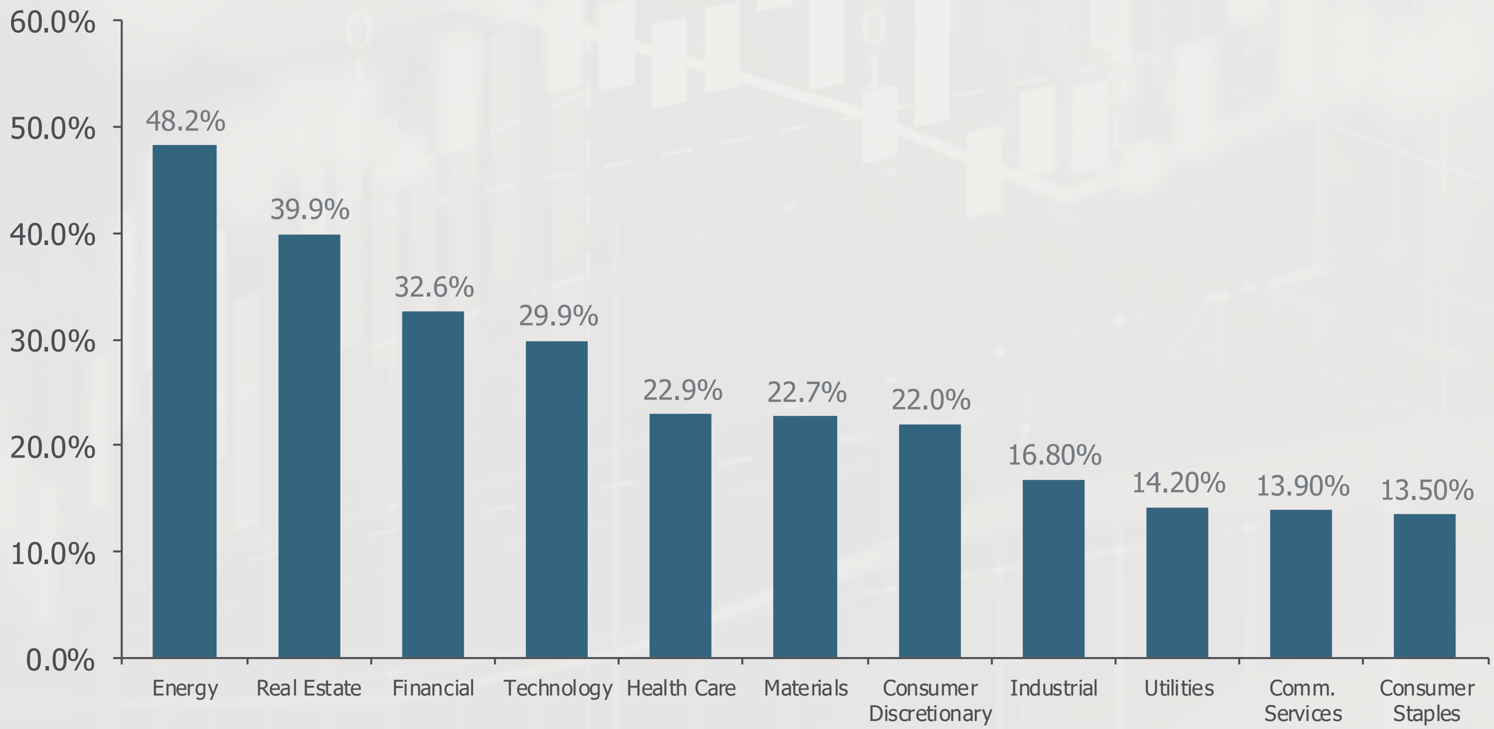
* 3/31/2021 was when the 10-year yield reached its intra-year high

- Yields are higher than where they started the year; mostly because of the short end of the curve rising. The ten-year reached its intra-year high (1.74%) on March 31, and the long end of the curve flattened during Q4, signaling market expectations for lower long-term growth.
- Investment grade corporate and municipal yield spreads were relatively stable in 2021, driving fixed income investors to look for higher yields. Consequently, high yield spreads have tightened by 50 bps (from 360 to 310).
- As spreads have tightened and we have seen record inflows, the environment feels like bonds are being "priced to perfection." We believe there are ample names with a little story that can generate more yield, without reaching for those yields in far more uncertain baskets.

Equity Sector Performance and Outlook – A Stock Picker's Market

We leveraged a barbell approach all year to capture returns across diversified industries and remained patient with our long-term investment philosophy. Energy, Financials, Metals/Mining and Consumer Discretionary fared well in 2021, alongside the FAANG+M group – the combination being the very definition of diversification.

YTD 2021 Total Return by Equity Sector



Source: FactSet (chart)

Equity Sector Performance and Outlook – A Stock Picker's Market

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In H1 2022, we want exposure to cyclicals, reopen ideas and **financials** – the latter typically benefit from rising rates. We still like **energy** in a supply-constrained environment with significant cash flows from existing operations. Those cash flows are being reinvested towards sustainable, lower carbon projects that will make certain companies a key part of a greener future.

We like **industrials** as well for their role in helping to meet the significant demand for additional capacity, logistics and inventory builds. On the heels of impressive company free cash flow numbers and supply chain improvements, we anticipate capex to recover from the decade-long lack of interest or priority.

Lastly, **health care** is trading at attractive valuations, creating an opportunity to invest cash flows from COVID-related products into other products and pipelines. These new products should start to make headlines and drive revenues and dividends. We also like quality **technology** and the total addressable markets they offer.

In H2 2022 we could see a more defensive shift in the market – much as we've seen in the past few weeks – due to tighter Fed policy and less stimulus. We'll be watching the data all year long to see if we need to adjust our positioning. We continue to believe that our approach, process and valuation discipline should be rewarded.

Six Secular Themes to Watch in 2022

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We are bullish on companies with large total addressable markets and secular growth opportunities.

1 Supply chain challenges have contributed to elevated demand for automation technologies that improve efficiencies and productivity. An increase in capex should help fuel additional capacity and inventory builds.

2 Semi-conductor shortages have highlighted the significant demand for electronic components in automobiles, robotics, medical devices and more.

3 Companies are investing in their cloud infrastructure to meet business demand for more data intelligence, transparency and storage.

4 Cybersecurity will continue to be a key investment theme as cyber-attacks become more prevalent and a critical threat to financial systems and corporate governance.

5 Artificial intelligence is playing a role across numerous industries. Machine learning can help businesses perform more efficiently and create unique value opportunities.

6 Healthcare, as was demonstrated throughout the pandemic, is crucial to society. Several industry leaders and disruptors, fueled by new investments, are poised to help shape the future with science, technology and their services.

Disclosures

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All returns data and statistics are sourced from FactSet, unless otherwise noted. Returns data as of December 17, 2021.

Thank You

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