Red Cedar Investment Management

Outlook 2022

December 2021

John Cassady III, CFA
Chief Investment Officer

Mitchell Stapley, CFA
Director of Macro Strategy

Reflation Nation or Inflation Nation?

> Inflation is as violent as a mugger, as frightening as an armed robber and as deadly as a hit man.
> – Ronald Reagan

Prior to the 1990s, the United States' economic cycles were generally shorter and characterized by boom/bust cycles. The Federal Reserve (Fed) would generally ease monetary policy in response to an economic slowdown or recession. As the economy healed and recovery took hold, the Fed would traditionally stay the course with its easy monetary policy, allowing inflation to gradually creep into the economy.

The Fed would often be reluctant to take away the monetary stimulus—either due to political pressure or under the mistaken idea that they could quickly tame inflation by tightening monetary policy later. Either way, they were typically behind the curve on fighting inflation, causing them to play catch up later by tightening aggressively until something broke. With the ending of the economic cycle, the entire process would begin anew with the Fed embarking on yet another easing cycle.

As the 1990s unfolded, the United States made the decision to outsource its manufacturing base to emerging economies. Under the banner of Globalization, it included the North American Free Trade Agreement (NAFTA) and the start of trade deficits with China.

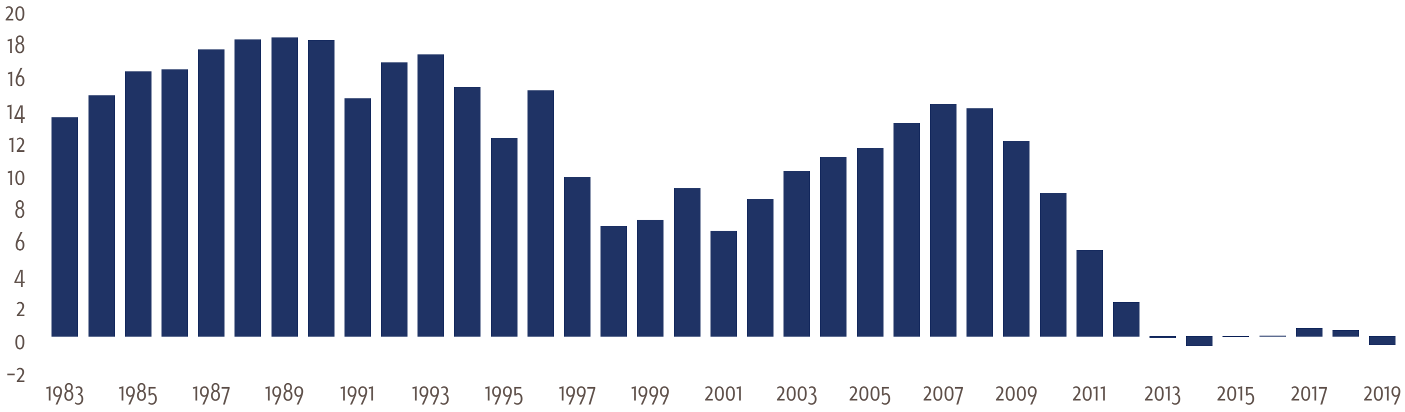
U.S. Trade Balance with China (in USD billions)

Source: United States Census Bureau/Foreign Trade.

RED CEDAR INVESTMENT MANAGEMENT

By the time China joined the World Trade Organization in 2001, there was no turning back. Besides, with the memories of the 1970s and early 80s inflation still fresh, it allowed the U.S. to achieve relative price stability by importing cheap goods from the rest of the world. As the graph below shows, China was able to export **disinflation** as they provided a steady supply of roughly 10 to 15 million new workers per year to the global workforce for nearly 30 years.

China Population 20-59 Years Old, 1983–2019 (YoY change in millions)



Source: United Nations, Gavekal Research/Macrobond.

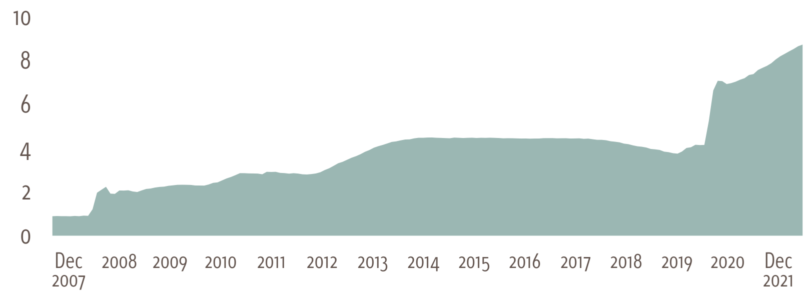
This glut of cheap labor enabled the U.S. to enter the era of the "Goldilocks" economy where it was rarely too hot or too cold, rather it was "just right." This allowed the Federal Reserve to keep interest rates at relatively low levels without the consequences of stoking inflation. While there were other consequences such as asset inflation, bubbles, and eventually the emergence of a moral hazard in the capital markets, the cost of capital was going down and economic cycles were longer. When economic calamity did strike in the form of the dot com bust, Great Financial Crisis, and finally a Global Pandemic, the Fed Put was implemented to rescue investors and the economy. With the low inflation environment thanks to globalization, the Fed could cut interest rates, buy government bonds, and provide liquidity facilities to prevent risky assets from declining in value, with little fear of fanning the flames of inflation. In short, the Fed Put existed because they could bail out everyone with no inflationary consequences.

> The Fed Put existed because they could bail out everyone with no inflationary consequences.

In the latest edition of the COVID-19 Fed Put, the central bank immediately took the Fed Funds target rate down to zero (again), where it has remained ever since. They also resurrected the Quantitative Easing (QE) program and have ballooned their balance sheet from $4.2 trillion in March of 2020 to $8.7 trillion in December of 2021.

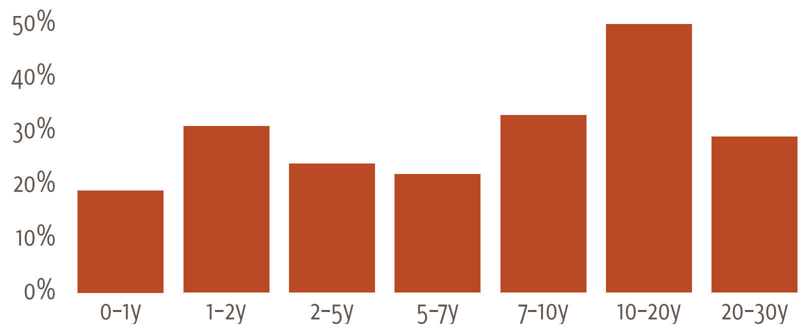
In fact, the Fed owns over 30% of all outstanding USTs in the 7- to 10-year maturity range, and 50% of issuance in the 10- to 20-year range.

Federal Reserve Bank Balance Sheet (in USD trillions)



Source: Federal Reserve Bank of New York, Richard Bernstein Advisors.

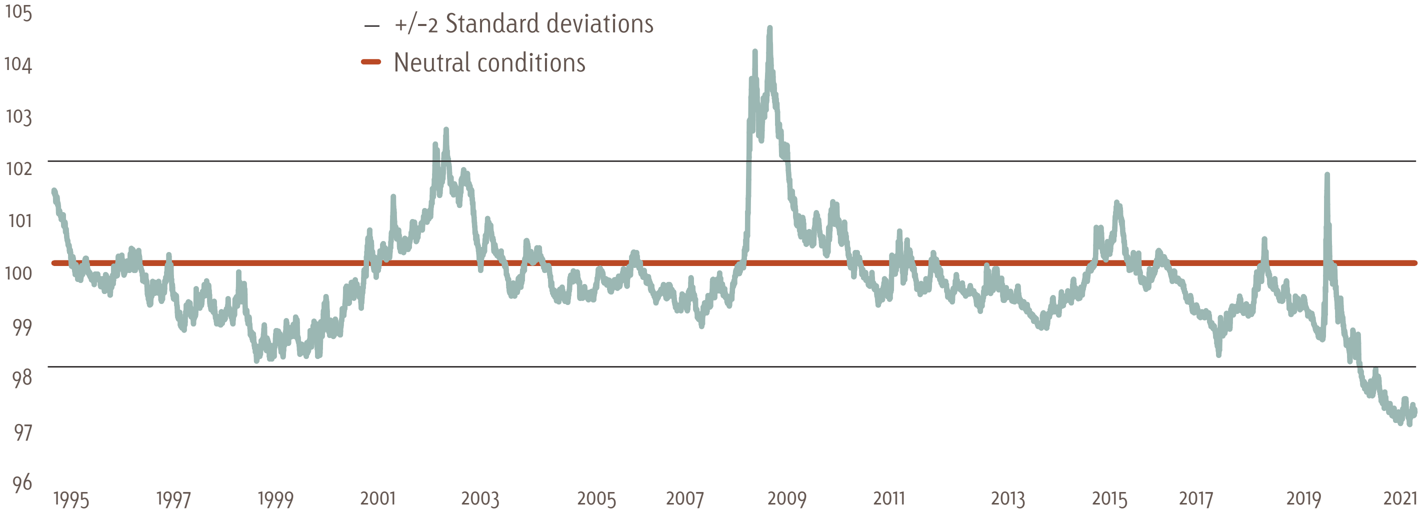
Fed Ownership as a percent of UST Market (as of September 2021)



Source: Federal Reserve Bank of New York, Richard Bernstein Advisors.

According to the Federal Reserve Bank, they have purchased $40 billion per month of mortgage-backed securities and $80 billion per month of USTs since they embarked on the COVID-19-related QE program. This has led to unprecedented easy financial conditions and liquidity the markets enjoy today.

Goldman Sachs U.S. Financial Conditions Index

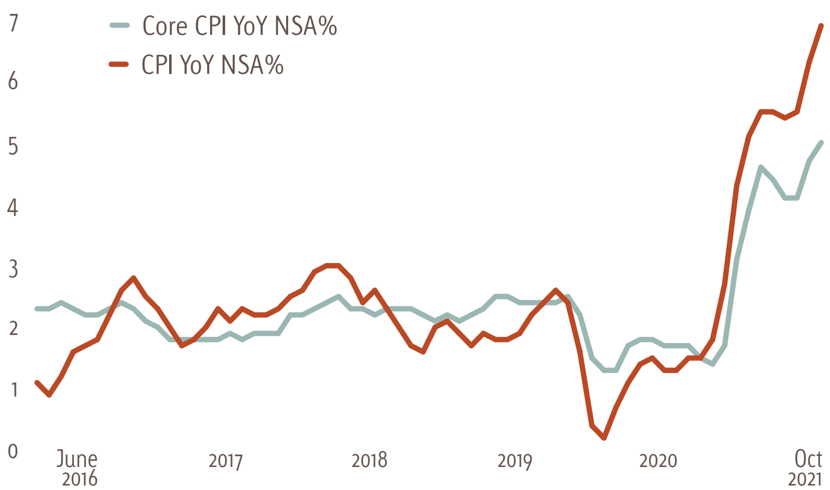


Source: Goldman Sachs, Bloomberg.

In addition to monetary stimulus, the COVID-19 fiscal stimulus amounted to 10.4% of GDP in 2020 and 11.1% in 2021, according to Strategas. Much of this stimulus was sent directly to U.S. consumers in the form of checks. Throw in breakdowns in fragile supply chains which are overly reliant on China, and the U.S. is now experiencing price increases like it hasn't seen since 1982 when Paul Volcker was fighting an outright war on inflation.

One year ago, if we had told you that the U.S. Consumer Price Index would be running at 6.8% year over year and core inflation was running at 4.9%, what would most investment professionals have projected the yield of the 10-year U.S. Treasury Note?

U.S. Inflation



Source: Bureau of Labor Statistics, Bloomberg.

Would anyone have guessed 14%? That's what the yield was the last time inflation was in the vicinity of 7% back in 1982. By the end of that year, yields had dropped to 10.5% as inflation had receded to 3.8%. With that as our historical reference, the 10-year nominal Treasury yield sitting at 1.5% makes absolutely no sense and offers no semblance of value. As of December 15, purchasing a 10-year Treasury Inflation Index Note would produce a real yield of -1.03%. In other words, if held to maturity, an investor would lose 1.03% in real purchasing power. Due to the unintended consequences of QE, the 10-year UST is no longer a reliable pricing mechanism that can give investors useful signals about the capital markets or the economy. It is artificially controlled by the Central Bank.

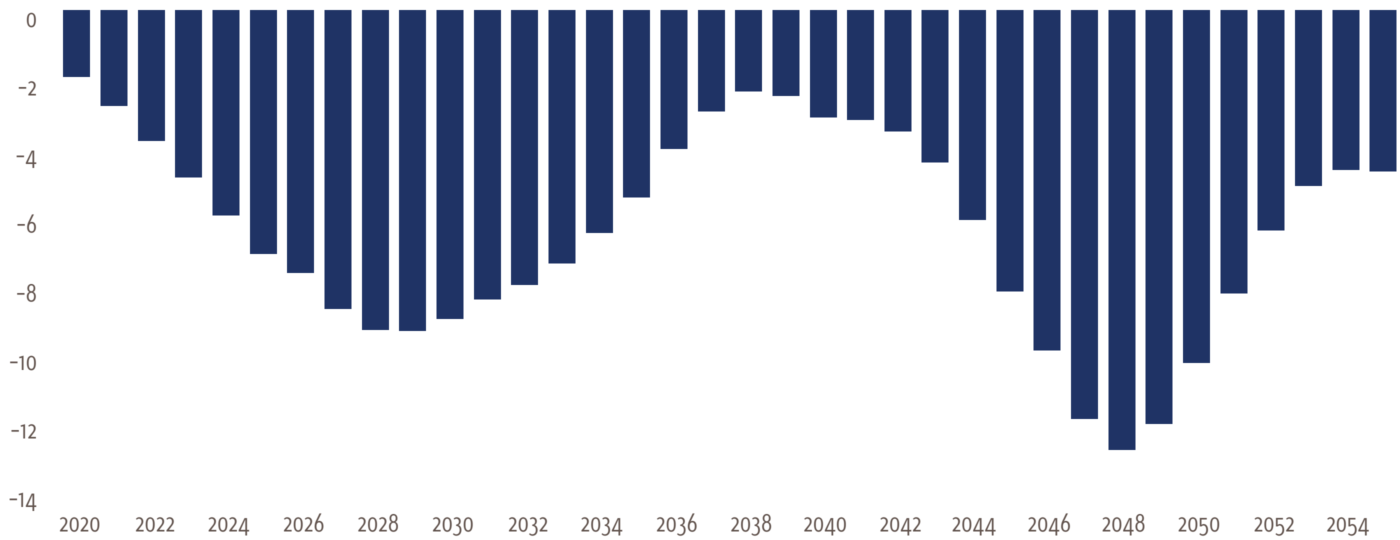
Following 30 years of relative disinflationary bliss, the institution that is the Federal Reserve Bank took a rather cavalier attitude towards the inflationary impulses that were clearly being unleashed upon the economy. The arrogance of the transitory narrative on inflation conjures up memories of Mad Magazine cover boy Alfred E. Neuman and his motto, "What, Me Worry?"

Over the past few years, structural changes have emerged in the world that could represent a material change from the halcyon days of globalization and the low inflationary regime of the past 30 years. If China's emergence as a manufacturing powerhouse was the prime reason for disinflation, then we need to examine their role on the world stage moving forward. Former Clinton Treasury Secretary Laurence Summers recently stated:

> To the extent to which China has lied at the heart of globalization and outsourcing for the past two decades, the pandemic, it would appear, has irreparably damaged China's brand and the ability of developed economies to import disinflation.

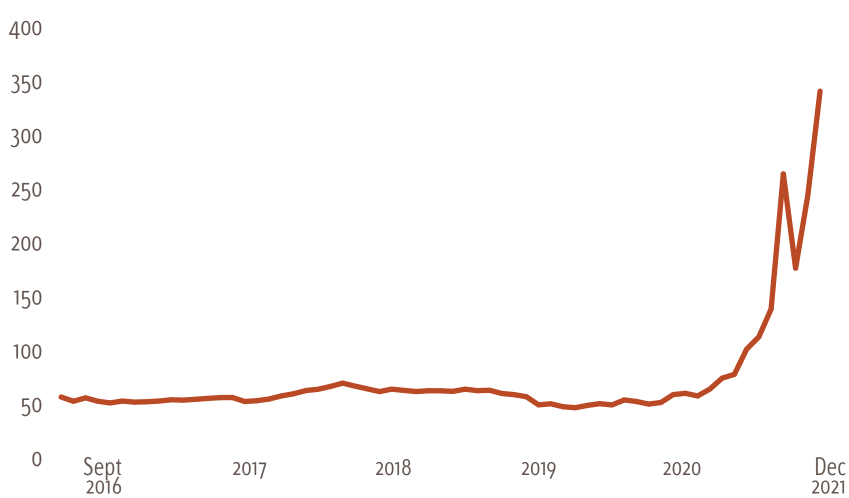
With China's reputation damaged and the pandemic-related supply chain disruptions, corporations are now working to diversify these supply chains with onshoring being a part of the solution. Moreover, thanks to China's decades-long One Child Policy, they will no longer be adding to the global workforce. As the graph below shows, they are now at the precipice of subtracting five to 10 million workers each year from the workforce.

China Population 20-59 Years Old, UN projection, 2020–2055 (YoY change in millions)



Source: United Nations, Gavekal Research/Macrobond.

ICE UK Natural Gas Futures Active Contract (GBP/therms)



Source: ICE Futures, Bloomberg.

As western democracies, and even China to some extent, have moved to become "Greener", these structural changes have caused other inflationary impulses to ripple through the economy. While pursuing clean energy is certainly a worthwhile goal, **the current ability to supply it is far less than the amount needed.** At the same time, western governments and activist investors have enacted legislation and governance that have starved the traditional energy sector of capital. The result is a dearth of capex in traditional energy, which has limited production and increased its price. With energy shortages (both green and carbon-based) occurring across Europe, there has been an uptick in energy prices globally. For example, natural gas prices have increased nearly sevenfold in the U.K. as the market realizes that current gas stockpiles and green energy will not be enough to heat homes during the winter months.

As global energy prices rose in the early to mid-2010s, the U.S. energy producers invested heavily in fracking technology. As these investments began to pay off, the United States became a net exporter of oil and gas, driving oil prices from over $100/barrel into the $40 range. So far in 2021, there has not been a similar response in capital expenditures from energy producers as the future use of carbon-based energy is called into question. The global community's resolve to slow or halt global warming is indeed moving in the right direction—the issue is that some of the governance and legislation was put in place before the widespread availability of green energy. In other words, there was not a bridge to get to the other side, one that must involve some traditional energy. It is our view that this could take five to 10 years to play out and the result will be higher energy costs.

The Federal Reserve is potentially now behind the curve on fighting inflation, and it might be time to retire the Central Bank playbook from the previous three decades. While we don't foresee a return to double-digit inflation of the 1970s, the markets and the Fed might have to adjust to a new normal of 3% to 4% inflation for the next few years. The most important takeaway from this could be the disappearance of the Fed Put as fighting inflation just might be the top priority over the next few economic cycles. This could result in shorter, more volatile economic cycles as well as higher equity and interest rate volatility. If this were to occur, markets would have to re-price risk away from the rather benign risk environment created by the Fed Put.

INVESTMENT THEMES

As outlined above, the investment themes for 2022 revolve around inflation, the Fed's reaction function, and whether it chokes off growth. So far, the Fed has committed to tapering and should be done by March of 2022. They have also told us they will not begin hiking rates until after the taper is complete. We look for nominal Treasury yields to rise as the Fed completes tapering. Even if we assume they will hike rates at some point next year, we still believe this cycle has some room to run. Afterall, it's not the first rate hike that slows the economy—it's the last one when they break something.

Be prepared to pivot to a defensive posture on the prospect of a Fed policy error or stubborn inflation.

As we enter 2022, we favor a moderate overweight to equities. While current valuations of the S&P 500® are not cheap at 20.4x next twelve month's earnings (FactSet), stocks do offer a better value proposition than bonds. Moreover, we expect earnings to grow at 20% in 2022. Equities can be a hedge against inflation if companies can pass along the higher costs. Be prepared to pivot to a defensive posture on the prospect of a Fed policy error or stubborn inflation. While this is not our base case, it is certainly within the realm of possibility as they attempt to fight inflation. Style-wise, we moderately favor value over growth, based on a better valuation proposition.

We would advocate investing in the energy sector based on the problematic supply/demand dynamic outlined above. Another way to play this would be through broad based direct commodities exposure. The copper exposure in commodities would also be beneficial due to increased demand for the red metal. According to Strategas, it takes four times as much copper wiring for an electric vehicle (EV) relative to an internal combustion engine vehicle. As EV demand continues to pick up, supply could lag as copper producers have been slow to increase capex in an industry that notoriously has an extended lead time to get new projects into production. The chart on the right shows the high percentage of metals production needed just to meet Tesla's production needs. REITs could also perform well in a moderate inflationary environment.

Metals Tesla Needs to Build 20M Cars a Year

Tesla Production @ 20M	Material Required (t)	Production 2019 (t)	% of Production
Graphite	1,028,775	1,100,000	94%
Nickel	750,410	2,460,000	31%
Lithium	127,302	77,000	165%
Copper (vehicle)	1,820,000	21,000,000	9%
Manganese	20,811	19,000,000	0%
Cobalt	68,315	122,000	56%
Aluminum (battery)	16,544	64,000,000	0%
Aluminum (vehicle)	3,380,000	64,000,000	5%
MagREO (NdPr, Dy, Tb)	18,000	46,000	39%

Sources: Mining.com EV Metal Index, Strategas.
Battery graphite, nickel, cobalt, lithium, manganese, MagREO, (NdPr, Dy, Tb): Adamas Intelligence
Production: USGS, BMO, Morgan Stanley, BP. Fitch, Excl. synthetic graphite
Copper, aluminum (vehicle): UBS estimates of Chevy Volt

In fixed income, we favor a defensive posture (shorter duration) for interest rate risk as the Fed tapers. In the credit markets, we favor an up in quality bias as credit spreads are extremely tight. Preferred securities offer an attractive way to add income to the portfolio in companies with decent balance sheets. As central banks globally are no longer in a synchronized monetary policy cycle, look for opportunities where central banks might be embarking on an easing cycle. China Government Bonds offer relatively attractive yields and the People's Bank of China (PBOC) could be poised to ease. Other higher yielding EM debt may seem attractive but historically, many of those countries have a difficult time keeping inflation at bay.

WHAT TO WATCH FOR IN 2022

- **Watch both nominal and real economic growth rates and the interplay with inflation.** For example, an 8% nominal GDP growth rate with 4% inflation could be good for the economy and equity markets. A stagflationary scenario of 5% nominal growth and 4% inflation would not be good for many risky assets.
- **Pay attention to corporate profit margins.** The 3Q21 net profit margin for the S&P 500® was a healthy 12.9% per Factset. They estimate 4Q21 net profit margin at a still respectable 11.8%. If inflation begins to be a drag on the economy, it will show up in profit margin compression at the corporate level.
- **Watch the yield curve.** While it is no longer the free-market indicator it once was, a flattening or inverted curve could indicate a recession is on the horizon within the next year.
- After the COVID-19-induced shift in demand from services to goods in the domestic economy, **will we see a shift in demand back to services** where we should have fewer supply chain issues and inflationary impulses?

RED CEDAR
INVESTMENT MANAGEMENT

Michael Feldhaus Director of Sales and Marketing
1404 Vine Street, 2nd Floor, Cincinnati, OH 45202
(513) 317-6829 cell
(513) 345-4414 direct line
www.redcedarim.com

Index Definitions

S&P 500®: Broad-based measurement of changes in stock market conditions based on the average performance of 500 widely held common stocks.

Consumer Price Index (CPI): Measures the average changes in price over time that consumers pay for a basket of goods and services.

Disclosures