Annual Outlook 2022

SHOCKING THE STATUS QUO

Ebrahim Busheri is the Director of Investments at Manning & Napier. In his more than 30 year investment management career, he has served as Director of Research and as the head of various sector groups within the firm. He has also served as Director of Investments and as a consultant at other firms.

From my viewpoint

Ebrahim Busheri, CFA
Director of Investments

The present is a unique time. The pandemic has had an enormous impact on our society. Short of the World Wars, a singular event has not uprooted so many social, cultural, and economic norms in a long, long time.

If in January 2020, I said that in a short two years, a hundred million plus of us would be working from home full-time, you would have looked at me and thought I was crazy. And then you might have asked the natural follow up inquiry of, 'Oh no. What happened?!'

This is only one example of how life has changed, but it highlights the uncertainty of the moment. Will these workers return to the office, or will they not? A plethora of other issues are facing these exact unknowns. Supply chain bottlenecks, rising inflation, urban flight, and so many more, each with enormous consequences on our economy and global financial markets. While some risks are likely to pass in time, others are creating huge opportunities.

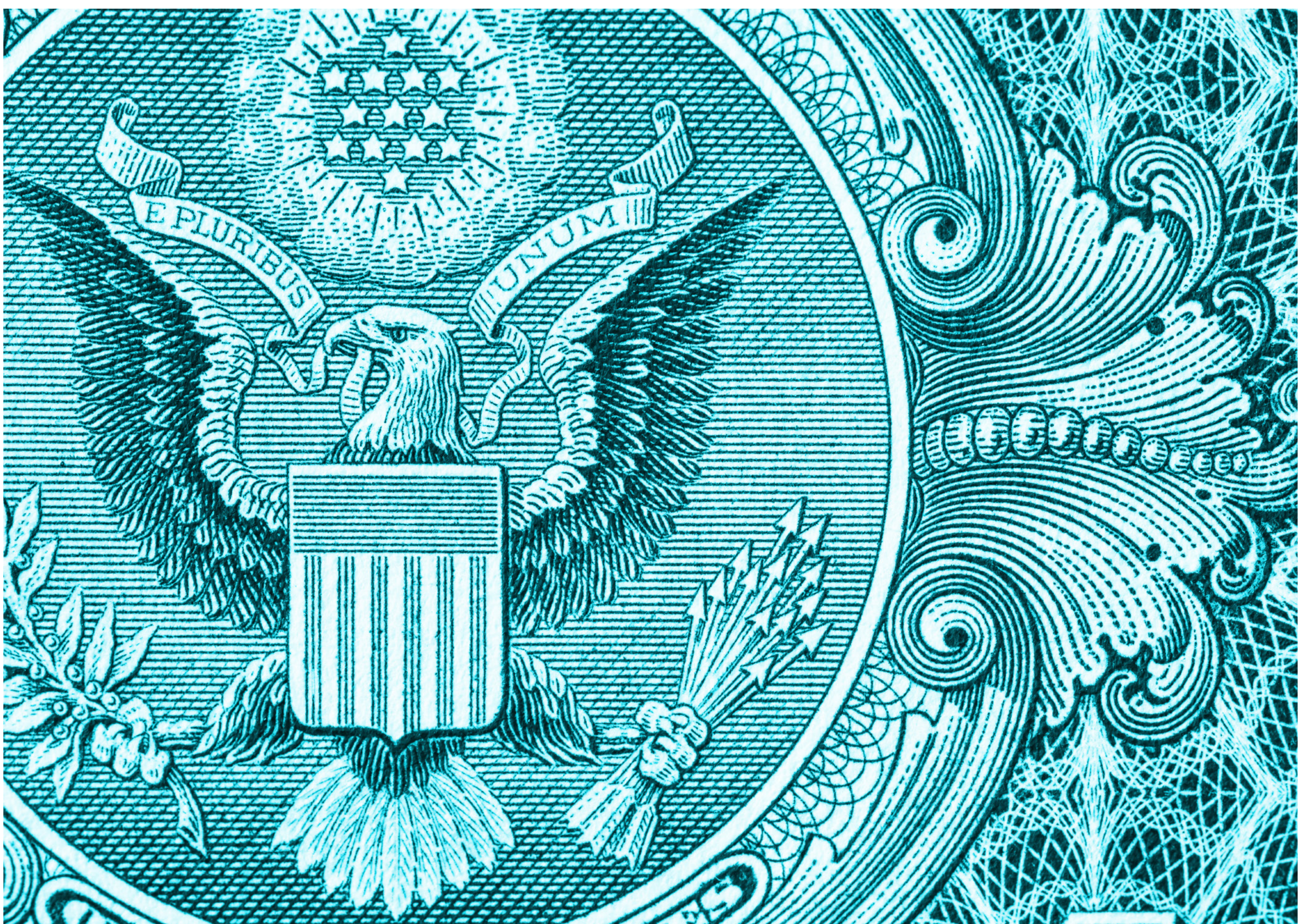
Many seasoned investors like to reference an old saying that resonates with me today: "When others are fearful, be greedy. And when others are greedy, be fearful." The economic and market boom of the past year and a half has been driven, in part, by monumental investor optimism surrounding the value of those trends. And while our world has changed, market axioms of fair value, growth at a reasonable price, the law of large numbers, and more, all unwaveringly remain.

Investors have every right and reason to look ahead with optimism that we can remake the world a better place than it was before. But whether markets like and place value on those opportunities is a different question entirely.

You can trust that we will continue to thoughtfully, diligently shepherd your financial future forward as our economy and financial markets sort through these unknowns. Thank you for your partnership.

The easy money has been made

The economy has moved beyond the early-cycle stages that are the best times to take on risk.



The massive puzzle that is our highly optimized and interconnected global economy has been shaken up and knocked around over the past two years, and we're only just now starting to see how the pieces are going to come back together.

Economic activity has bounced back, and businesses have persevered. Revenue growth is strong, corporate profitability is near all-time highs, and business sentiment is good. Yet a degree of today's boom is also a result of extraordinary policies and staggering stimulus measures, plus a historic one-time wave of pent-up consumer demand.

Those forces acted as huge winds behind the sails of markets and the economy, but they could not go on forever. Monetary policy is beginning a process of normalization, fiscal support and stimulus measures are lessening, and the labor market is showing increasing signs of tightness, with higher inflation and higher wages as clear signs that cyclical risks are building.

A turning point is nearing as these tailwinds start to fade, and as they move aside, what's left is rather unusual this soon after a recession. For example, US bond markets are already expecting multiple interest rate hikes next year, and fiscal spending is projected to be an order of magnitude smaller than the past few years. Excess consumer savings rates from the early days of the pandemic have already been spent down, and inflation has notably picked up, now reaching multi-decade highs.

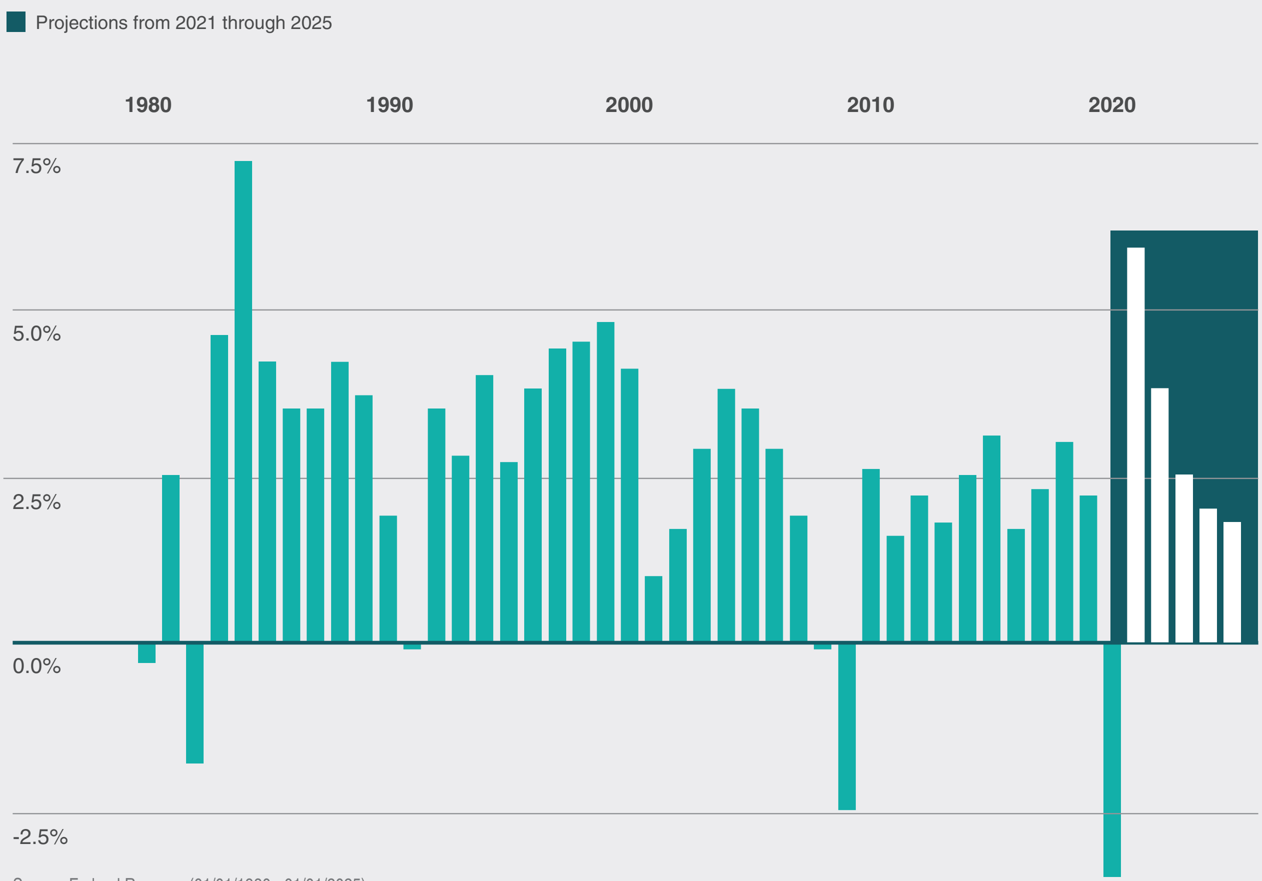
These indicators and others tell us that the economy has rapidly moved through the cycle. We see the US in at least a mid-cycle phase, with some indicators even showing later-cycle tendencies. This is very quick, and it means that investors should start to show some degree of caution.

The cautiousness extends beyond the economic cycle and into our longer-term views as well. The two twin issues of a mediocre demographic profile and elevated debt levels remain major weights on potential growth. Baby boomers stepping out of the labor force are the most significant contributor to today's labor market shortages, and extensive debt-financed spending by both corporations and governments are likely to be met by lesser spending in the years ahead, particularly should interest rates rise. For these structural reasons, we believe growth is likely to slow, falling back toward its more sustainable, steady-state rate.

All of this is to say that our economic outlook has become increasingly reserved. To be clear, this shouldn't be confused with outright pessimism, but it does mean that we're emphasizing balance, care, and our selective, active approach.

2021 Growth Was the Highest in Three Decades

US Real GDP Growth



Source: Federal Reserve. (01/01/1980 - 01/01/2025).

We Expect Growth to Slow to More Sustainable Levels in the Coming Years

US economic growth has boomed this year, benefiting from policy, spending, and debt tailwinds that are beginning to dissipate. An economy can only grow as fast as its fundamentals allow, with poor demographics and high debt levels likely to drag growth back down in the years ahead.

A butterfly flaps its wings

The smallest of events can sometimes lead to the biggest of market impacts, which is why we use explicit monitoring points to help keep us diligent, thoughtful, and our eye on the ball.

Markets are synonymous with expectations. It's not enough to deliver growth. It's not enough to control costs. Good fundamentals are the starting point, but what markets really want is to know that those good fundamentals are going to keep getting better.

That additional ask is everything. It's the difference between investing for the future and simply picking stocks based on today. Understanding investor expectations is entirely forward looking, and that extra layer of thinking is what underpins investor psychology and drives the day-to-day movement in markets.

Stock's prices rise when companies beat expectations, causing investors to recalibrate what they think is possible from the business. Sometimes, investors get too excited. They get carried away and start paying too much for the stocks of those businesses.

When stock prices rise too high, looking too far into the future and not enough at the fundamentals of today, valuations rise and sharp volatility can strike. Areas of the market such as electric vehicle manufacturers, sports gambling brokers, and trendy at-home fitness companies, as well as private market trends in buyout and venture capital multiples, the SPAC boom, and cryptocurrencies all fit this description well. In other words, if the business is priced for perfection, and perfection doesn't happen, it can be any kind of catalyst that sparks a selloff.

Those industries are easy targets to pick on. Investors held unrealistic expectations, and for us, we see this as an opportunity to avoid unnecessary risk. We prefer to talk about the names that we do like, but sometimes, not owning something can be just as beneficial. Either way, today's market is providing a lot of opportunities to 'win by not losing'.

Where we *are* invested is in a smattering of themes, industries, and specific stock names across the economic spectrum. For example, we remain invested in many of the same secular growth stories that we've owned for years, including (but not limited to) cloud computing, payment processing, digital advertising, and gaming. We look at our multi-year holding period in these names as exhibit A of our long-term, full market cycle focus. In cyclical areas such as energy, we've trimmed exposures into price appreciation throughout the past year, and now hold a bit less exposure in those more value-leaning areas. Considering where we see the economic cycle today, we believe this is wise and prudent. Finally, we still own a variety of names that don't fit neatly into any particular bucket but are well captured by our stock selection strategies. These include unique opportunities in dollar stores, consumer staples, pharmaceuticals and biotechnology, real estate, and gold mining.

So while the market as a whole still has plenty of areas we like, that doesn't mean it isn't a good time to be smart, measured, and reasoned. Because when valuations are high, you never really know when you're going to appreciate having a little less risk and a little more balance.

Winning by Not Losing

Market concentration, unprofitable businesses, private equity, and more are all concerning. Being able to dodge risks and avoid market pitfalls may be one of our greatest strengths ahead.

The 10 largest weights in the S&P 500 make up 30% of the index, the highest in over 30 years.

Information Technology now has a 29.3% weighting in the market, the highest since 2000.

Tesla's weight is now over triple the weight of General Motors and Ford, combined.

The energy sector was once 16.2% of the S&P 500. Today, the sector accounts for just 2.7% of the index.

Private equity buyout multiples reached 13.2x annual EBITDA in 2020, an all-time high.

The global market cap of cryptocurrencies reached $3 trillion, roughly equal to the entire stock market capitalization of Germany.

The number of US-based unicorns (private start ups with valuations over $1 billion) grew by an average of 46 new start-ups, each month.

Within Communication Services, the top ten names make up 93% of the sector. For Industrials, the top ten comprise 39%.

The US stock market capitalization is ~215% of US GDP, the highest level ever.

All index/market measures refer to S&P 500. Analysis: Manning & Napier.
First row: Source: FactSet (01/31/1990 - 11/30/2021; 08/31/2000 - 11/30/2021; 11/30/2021).
Second row: Sources: FactSet (06/30/2008 - 11/30/2021), Reuters (2020), Bloomberg (in 2021).
Third row: Sources: Crunchbase (11/2021, FactSet (11/30/2021), Barron's (11/2021).

Between a rock and a hard place

Bond markets are putting investors in a difficult position. Play it safe, and get no yield; reach for yield, and take on a potentially scary amount of risk.

Interest rates remain historically low. We feel like a broken record. But there is not a more powerful force in bond markets, or perhaps all of financial markets, than the near half century long collapse in rates.

Perpetually lower interest rates have been a potent tailwind for fixed income investors. Bond prices and interest rates move inversely, and as rates continued to fall, prices continued to rise on existing bond holdings. For investors with balanced or conservative portfolios, whose goals and objectives are income or a blend of both growth and income, ever lower rates have been a major performance boost.

What makes today's low-rate environment unique from prior low-rate episodes is the first serious bout of inflation in a long time. Real interest rates (interest rates when adjusted for inflation) are now deeply negative, meaning that US Treasury yields are nowhere near enough to overcome inflation's deleterious effects. This deeply negative real interest rate conundrum is reflective of today's challenging bond market environment.

As a result, many investors are choosing to take on more risk, either by increasing equity exposure or increasing credit and duration risks on the bond side. Each of these solutions are problematic in at least one way or another. For example, it may seem enticing to buy longer dated bonds for extra yield, but longer maturity fixed income would be particularly hard hit should interest rates rise ahead. We expect rates to gradually move higher, and we've positioned client portfolios as such.

Similarly, some investors are choosing to take on extra credit risk in 'junk' bonds and other riskier debt. This may boost yields today, but should the economy go south, those issuers may have trouble supporting their debt obligations. And as we highlighted earlier in this outlook, the economy appears to be in the middle- to later-stages of the economic cycle, not exactly the time to be loading up on risk.

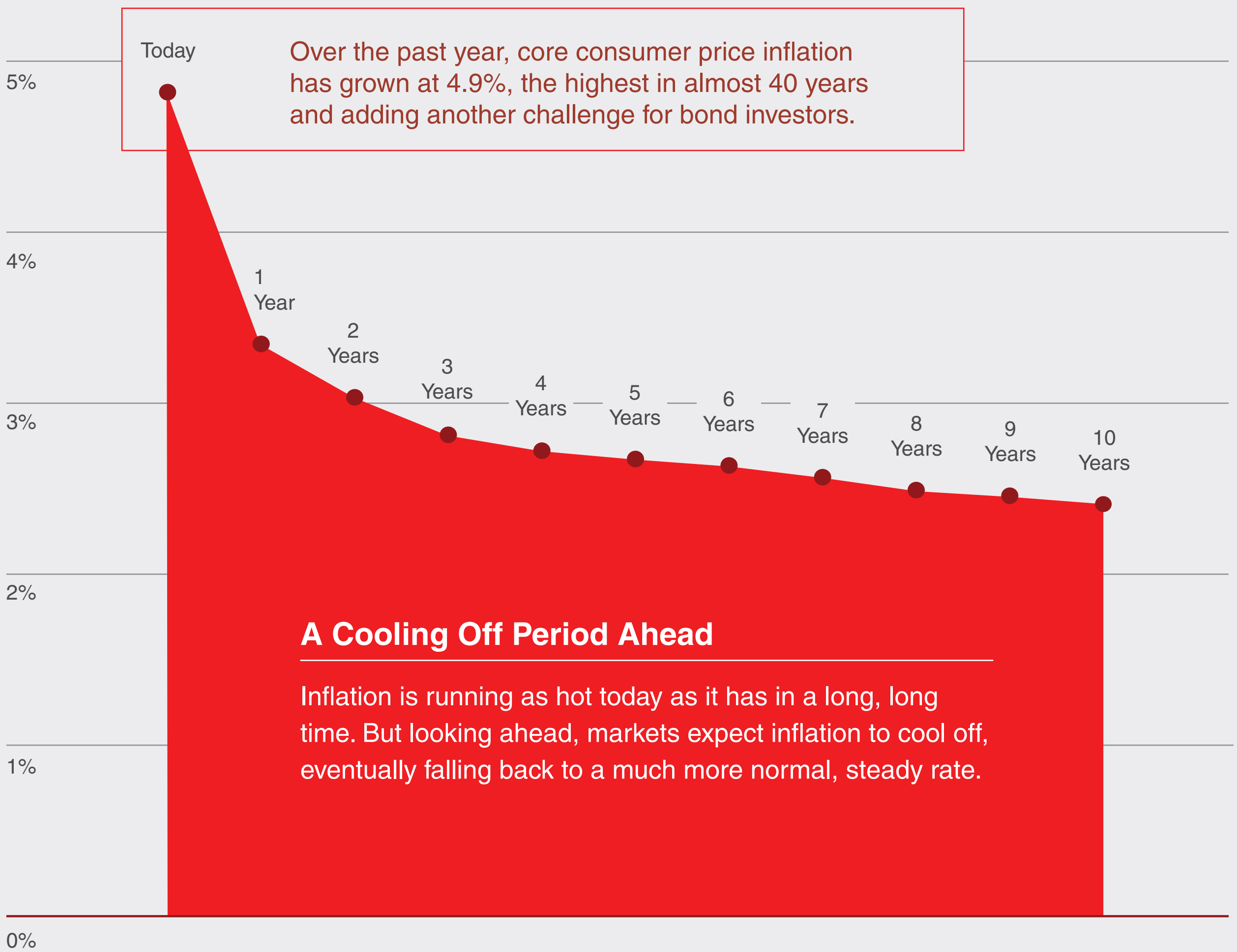
All of these issues then come back to the grand question of: Why own fixed income at all? Bonds play a critical role in diversification, downside protection, and risk management, something that is rarely appreciated by investors until it is too late. Additionally, when fixed income is viewed alongside an equity market that expensive by almost any measure, then the stable characteristics of bonds start to make much more sense.

Bond investors are in a tough spot. If you accept less, you'll get less, but that doesn't mean there isn't opportunity to be had. By doing the hard work, the due diligence, the deep dives, and the digging, we believe we can deliver better. Our fixed income team has continued to unearth value in a variety of corporate bonds, asset-backed securities, securitized credit, and other types of loans. We're searching through all sorts of niche areas from issuers ranging from auto parts manufacturers to aircraft leases, hunting in markets that we believe are overlooked by most run-of-the mill-advisors.

It is in the work and the willingness to go above and beyond that investors can get more from a difficult hand. If it was easy, everyone would do it. This is what we mean by better.

Making a Hard Problem Even Harder

US Inflation Rate and Forward Breakeven Rates by Year



Source: Bloomberg. (2021 - 2031).

Realistic expectations and your plan

Like rafting down a river, investment returns can be steered one direction or another, but you're going to go where the water takes you.

Everyone wants big performance. Stories, books, and entire legends sprout up around the rare years when everything goes just right. Yet even the best run of performance will eventually succumb to the trend of financial markets.

We see financial market performance as nearing an inflection point, and we strongly believe investors should recalibrate their expectations to lower, more realistic levels. The recent post-Global Financial Crisis run of annualized mid-teen US stock market returns, plus mid- to high-single digits bond market results, are each entirely unsustainable. Both US equity and fixed income markets have been on an extraordinary run.

In our view, there are three different stories to tell about future return expectations - and only two make sense. Today's low starting yields in fixed income, and high valuations in equities, make for a very difficult starting point. Additionally, our projections are for a deceleration, not acceleration, in economic growth, suggesting that the economy is unlikely to grow us out of this predicament.

If you were to ask whether we are rowing upstream, downstream or in flat water, you can likely imagine our answer. In our opinion, the tides aiding investors for much of the recent past are fading away. We see global financial markets as delivering returns either in-line with historic averages or falling short of them. We know that isn't a fun message to deliver.

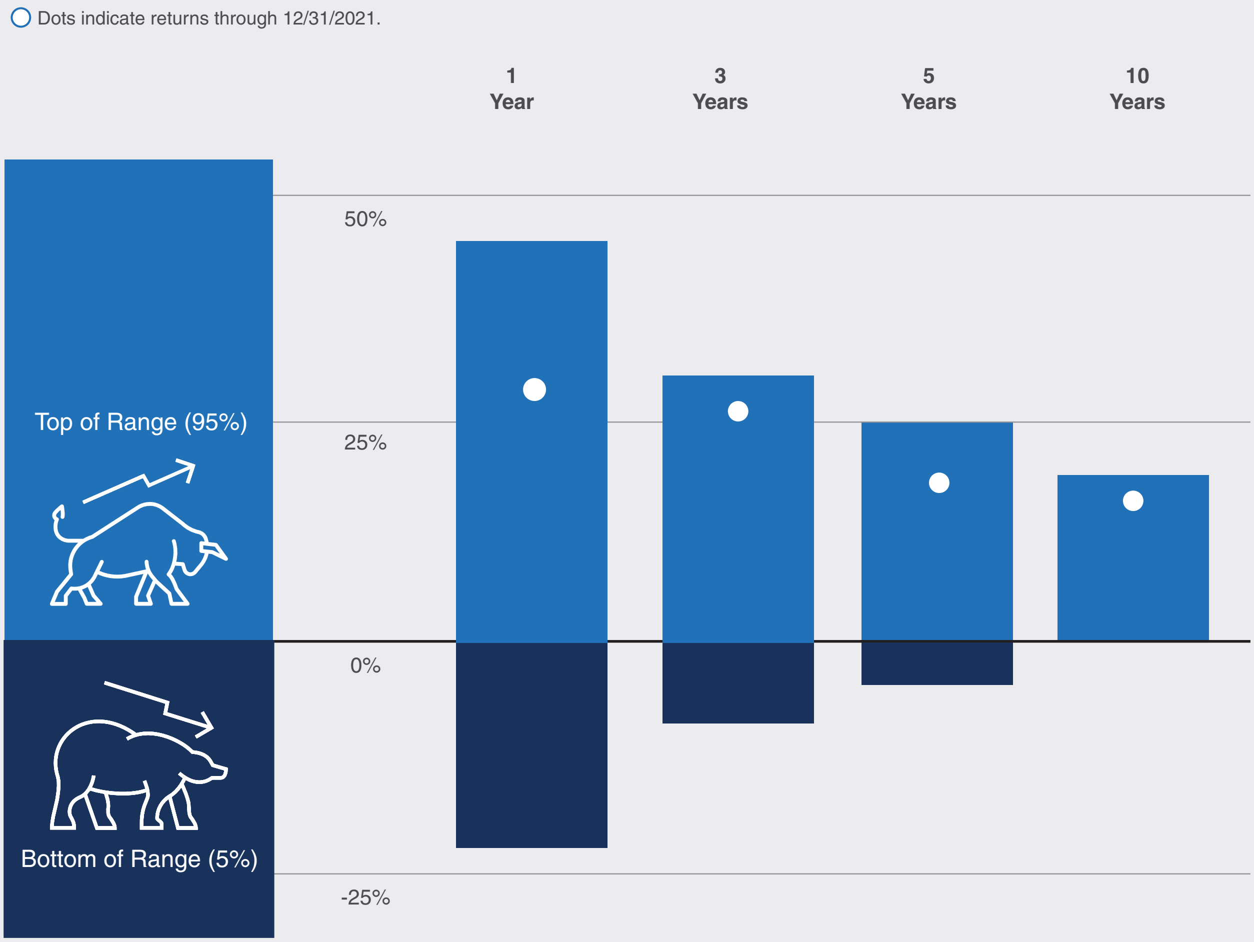
What we can deliver is a plan. A plan that is fully integrated from investments down to the things you actually can control. This means everything from asset allocation and risk management, to having conservative inflation and return assumptions, to spending patterns and the ability to deploy a dynamic withdrawal approach. These tweaks, changes, and strategic choices help us architect more solid, resilient financial plans. Plans designed to weather a storm.

Your Financial Consultant team is available 24/7 to guide you on how you can deploy your most powerful tool: time. We're here to talk through these challenges and ensure you are on track to meet your goals. We'll regularly review your financial plan and recommend adjustments as needed, and because we manage the investments too, you can trust that we will be fully accountable and accessible for your solution.

The waters are changing. Financial markets are no longer coasting downstream. The time to build in safety and security is now. Work with a wealth manager to help make that happen from start to finish.

S&P 500 Historical Returns

Best/Worst Performance by Time Horizon



Today

When financial market valuations are expensive, they are more likely to suffer over the short run. By using your financial planning tools and the power of time, you can set yourself up for success when the good times eventually give way to choppy weather.

Investing with a Plan

You can't control what financial markets are going to do, but you can control how you react. Markets are going to have their ups and downs. Take the time to plan today, so that when the markets get rocky, you're prepared and ready to make it through to the other side.

Source: Morningstar. (12/31/2021).

To learn more about our wealth management offerings,
please visit **www.manning-napier.com**
or contact us directly at info@manning-napier.com.

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