Calibrating Expectations

Manning & Napier's
Annual Outlook 2022

From My Viewpoint

EBRAHIM BUSHERI, CFA

Director of Investments

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.

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 of these 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. Our Investment Research team is dedicated to going security by security and risk by risk to make the best possible decision with the information at hand, each and every time.

On behalf of the Investment Policy Group at Manning & Napier, and as the Director of Investments of our team, I hope you enjoy this year's edition of our annual outlook, Outlook 2022: Calibrating Expectations. To all of the financial professionals we work with day-in and day-out, thank you for your continued partnership, and we look forward to continued success in the year ahead.

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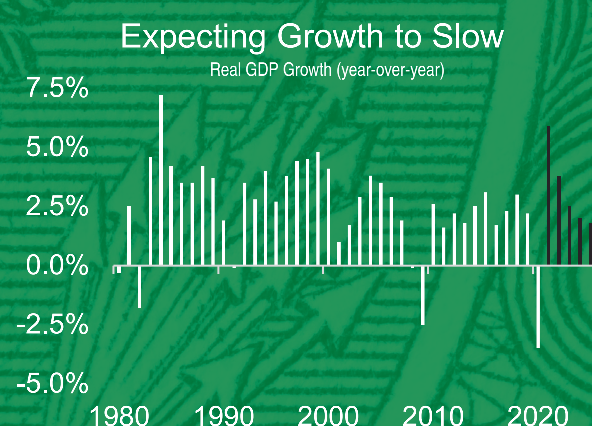
The easy money has been made

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 result of extraordinary policies and staggering stimulus measures, plus a historic one-time wave of pent-up consumer demand.



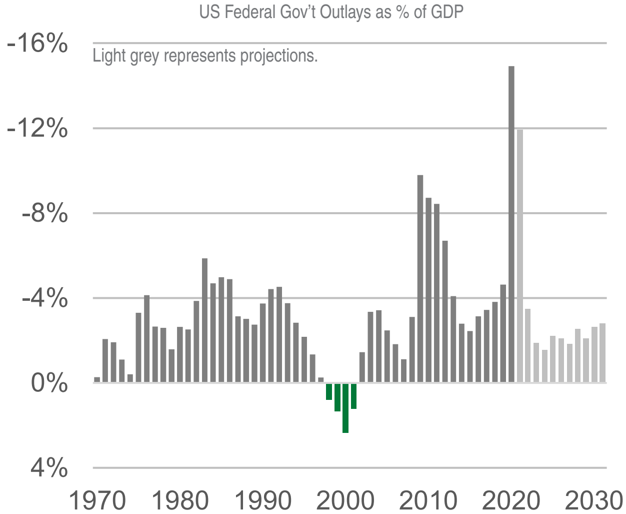
Source: Federal Reserve. (01/01/1980 - 01/01/2025). Gray bars represent projections from 2021 through 2025.

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.

The Looming Fiscal Cliff

US Federal Gov't Outlays as % of GDP



Source: Congressional Budget Office. (1970 - 2031).

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

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.

A butterfly flaps its wings

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.

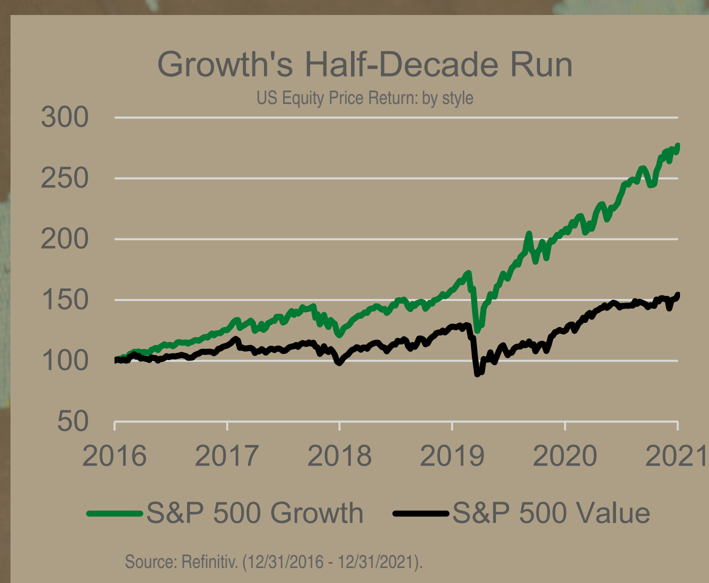
Stocks prices rise when companies beat expectations, causing investors to recalibrate what they think is possible from the business. Sometimes, investors get too excited. They get carried away and start paying too much for the stocks of those businesses.

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.

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.

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.

Building Risks in Public and Private Equity Markets

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).

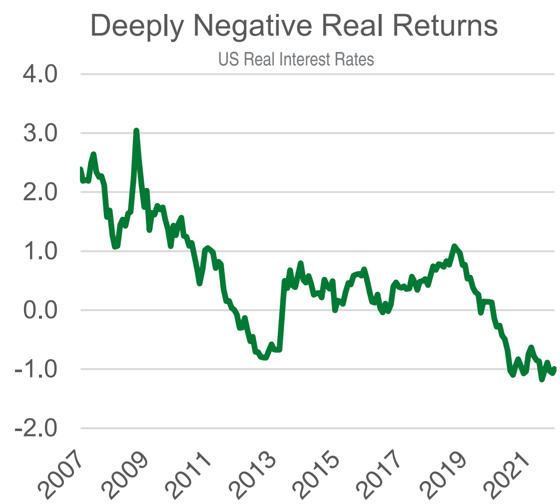
Between a rock and a hard place

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.

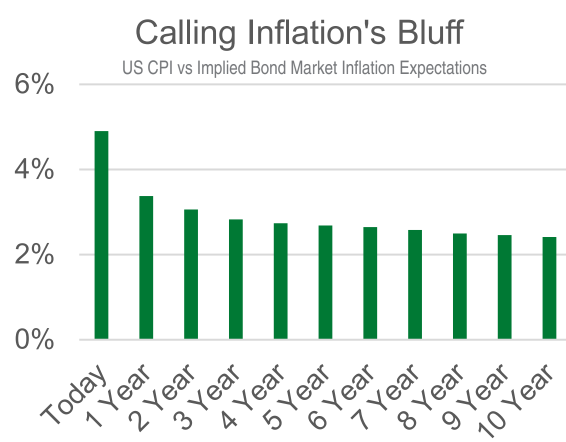
Perpetually lower interest rates have been a potent tailwind for fixed income investors. Bond prices and interest rates move inversely, and as rates continued to fall, prices continued to rise on existing bond holdings. For investors with balanced or conservative portfolios, whose goals and objectives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

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.

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 a today's challenging bond market environment.



Source: Refinitiv. (01/31/2007 - 12/20/2021).



Source: Bloomberg. (2021 - 2031).

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.

Setting realistic expectations

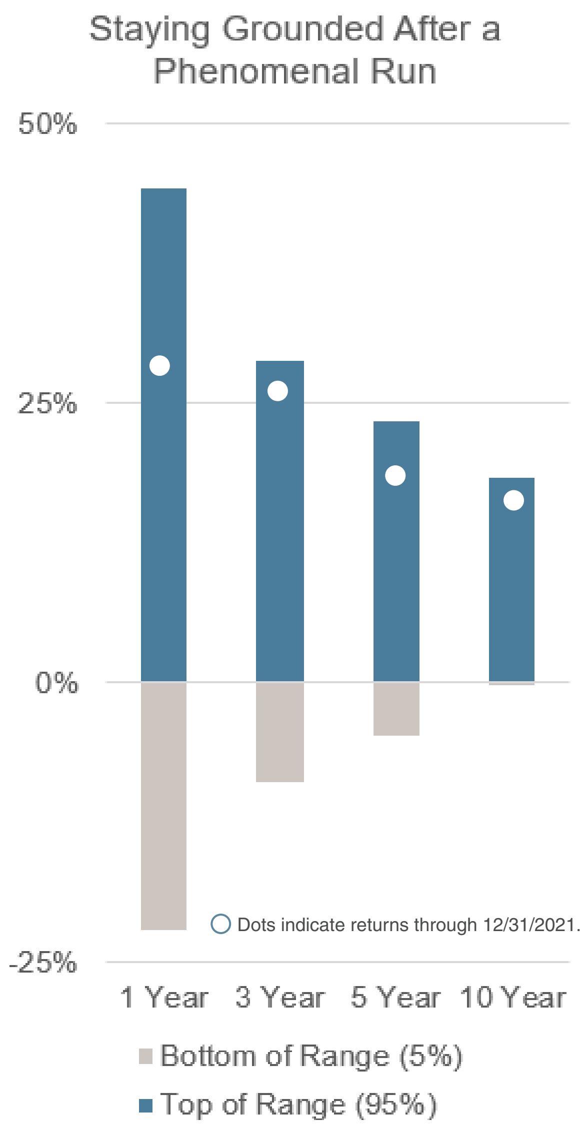
Everyone wants big performance. Stories, books, and entire legends sprout up around the rare years when everything goes just right. Yet even the best run of performance will eventually succumb to the trend of financial markets.

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's three different stories to tell about future return expectations and only two of them make sense.

Today's low starting yields in fixed income and high valuations in equities make for a very difficult starting point for investors. Additionally, our projections are for a deceleration, not acceleration, in economic growth, suggesting that the economy is unlikely to grow us all out of this predicament.



Source: Morningstar. (12/31/2021). Shows the S&P 500 Best/Worst Performance by Time Horizon.

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.

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.

The waters are changing, and we expect choppy conditions coming our way. Manning & Napier always employs an active and flexible investment approach in response to changing markets. While different conditions present their own set of challenges, we believe our core investment process is the key for providing attractive results over the long run.

Ultimately, as the markets continue their volatile ride into 2022, we remain dedicated to the core investment strategies we believe have served our clients well since 1970.

A Partnership You Can Count On

As we look to 2022, we can't help but reflect on how proud we are of the strong results we have been able to provide our Advisors and their clients over the COVID-19 pandemic. If ever there was a time for active managers to prove their value, this was the time.

For more on our award winning investment strategies, including a diversified lineup of actively managed mutual funds and ETFs, visit: **www.manning-napier.com/company/awards**

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The S&P 500 Citi Value Index is a market capitalization-weighted index consisting of those S&P 500 companies with lower book value to price ratios, lower earnings to price ratios, and lower sales to price ratios.

The S&P 500 Total Return Index is an unmanaged, capitalization-weighted measure comprised of 500 leading U.S. companies to gauge U.S. large cap equities. The Index returns do not reflect any fees or expenses. The index accounts for the reinvestment of regular cash dividends, but not for the withholding of taxes.

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