INVESTMENT STRATEGY INSIGHTS

Key Questions for 2022

January 3rd, 2022

Where are we in the pandemic recovery?

- The economy still has room to grow in the new year as it continues to normalize from the pandemic

Is the market too expensive?

- Investors should maintain a modestly overweight risk posture, with selective emphasis on small caps and global real estate

Will above average inflation persist?

- Supply chain disruptions will likely spill over into the new year, but their impact should eventually subside

GLENMEDE

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Where are we in the pandemic recovery?

- **An Eye on Omicron.** The COVID-19 omicron variant remains a key concern for investors heading into the last week of 2021, particularly whether it might become severe enough to warrant renewed lockdowns and hamper economic activity. However, a preliminary study in the U.K. showed people infected with omicron are 50% to 70% less likely to end up in the hospital. In addition, President Biden emphasized that he did not envision returning to lockdowns a la March 2020.
- **Room to Reach Potential.** As the new year approaches, it's helpful to take stock of where things stand in the ongoing pandemic recovery. At a high level, the economy continues its transition to post-recovery growth. The gap between actual gross domestic product (GDP) and potential GDP has closed significantly over the last year, but there appears to be room for improvement. On the other hand, earnings expectations in most major markets have already eclipsed their pre-pandemic highs, yet a favorable macro backdrop may be the tailwind that pushes earnings ever higher.
- **Fiscal Policy in the New Year.** Discussions in Congress regarding the Build Back Better bill continue into the new year. Regardless whether Congress can reach an agreement on the $2T reconciliation package, fiscal policy is likely to be an incremental headwind for growth in '22. This is due to the sheer size of pandemic stimulus over the past two years, which creates higher baselines for annual comparisons, as well as the nature of spending in the bill. The expected outlays would likely be spread out over multiple years, with some of the costs offset by associated revenue-raising provisions.

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Is the market too expensive?

- **Valuations Matter.** After another year of strong performance in markets, equities on the whole do not appear particularly cheap heading into '22. Glenmede's Global Expected Returns model suggests that an equity portfolio with diversified geographic and market-cap exposure currently sits at the 83rd percentile of longer-term valuations. However, there are meaningful disparities beneath the surface. U.S. large cap growth appears notably extended at the 99th percentile, while large cap value and small cap appear more reasonably valued.
- **Sizing Up Small Cap.** Heading into the new year, investors should consider tilting their equity allocations in favor of small caps. For one, they have a historical record of strong returns in the years after the official end of recessions. Since WWII, U.S. small caps have posted 37.8% and 59.0% cumulative total returns on average in the 2- and 3-year time periods directly following recessions. In addition, small caps have outperformed CPI inflation in every decade since the 1930s, likely reflecting a general ability of smaller companies to be nimbler around shifting price pressures.
- **Real Opportunities in Real Estate.** As far as risk-bearing asset classes go, few seem more attractive than real estate. Real estate investments stand to benefit from a number of macroeconomic crosscurrents: the economy is recovering, which should lead to higher occupancy rates and REITs have historically been among the best performing assets during periods of higher-than-normal inflation. Topping that off with 67th percentile valuations makes global real estate a compelling consideration for diversified portfolios.

Investors should maintain a modestly overweight risk posture, with selective emphasis on small caps and global real estate

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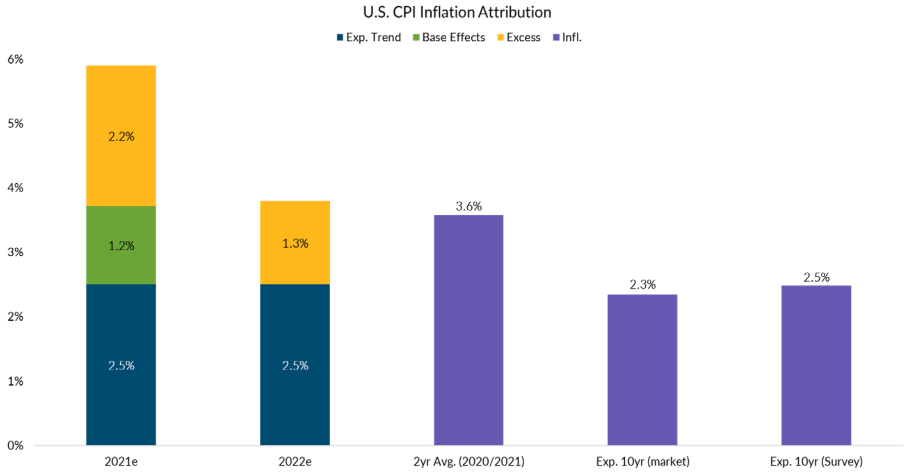
Will above average inflation persist?

- **Inflation Stays Hot.** November's print of the price index for core (i.e., excluding food and energy) personal consumption expenditures in the U.S. hit 4.7% on a year-over-year basis. This was a multi-decade high for the index, as the Fed's preferred measure for inflation targeting echoed the CPI's signal of sustained inflation momentum heading into year-end.
- **Monitoring Supply Chains.** Ongoing supply chain disruptions are one of the culprits behind hotter-than-normal inflation, as the supply of goods has been outstripped by record demand in some industries. There are some initial signs that these impacts may be abating – for example, after rising more than 550% since the beginning of '19, freight shipping rates (as measured by the World Container Composite Index) have started to show nascent signs of a near-term peak. Clearing the backlog of shipments may be key to wrestling inflation under control and boosting inventories. As of now, the percentage of industries in the ISM manufacturing PMI survey with consumer inventories that are considered "too low" sits just below all-time highs at 55.3%.
- **Inflation by the Numbers.** U.S. CPI is projected to be 5.9% on a year-over-year basis in '21. Although this is materially higher than inflation's longer-term trend of about 2.5%, 1.2% of that difference can be attributed to base effects, with the remaining 2.2% due to supply chain disruptions and labor market frictions. Base effects will be gone by '22, but some of the impact from supply chain bottlenecks and labor shortages are likely to spill over into the new year. Nevertheless, inflation should settle down longer-term to near-2.5%, as implied by the market and in line with the Fed's longer-term target.

> *Supply chain disruptions will likely spill over into the new year, but their impact should eventually subside*

Chart of the Week:

Some of the higher inflation should prove transitory, but some is likely to be more persistent



Source: Glenmede Data through 12/22/21

Data shown are various historical and projected figures for the U.S. headline consumer price index (CPI), which measures the change in the price of a basket of goods and services consumed by U.S. households. "2021e" and "2022e" are Glenmede and consensus expectations, respectively, broken down into long-term expected trend rate inflation, base effects and excess factors due to labor shortages and supply-chain disruptions. "2yr Avg" is the average of year-end inflation for 2020 and expected year-end inflation for 2021. "Exp. 10yr (Market)" is derived via market-based inflation expectations, which includes breakeven inflation rates on 10-year Treasury Inflation Protected Securities (TIPS) and 10-year inflation swap rates. "Exp. 10yr (Survey)" includes all the market-based inflation expectation components, alongside survey-based expectations via the Fed's Livingston survey. Past results may not be indicative of future results. Actual results may differ materially from projections.

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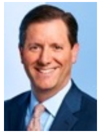

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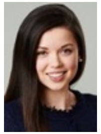

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GLENMEDE CORPORATE FACTS
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