FS INVESTMENTS®

Lara Rhame's

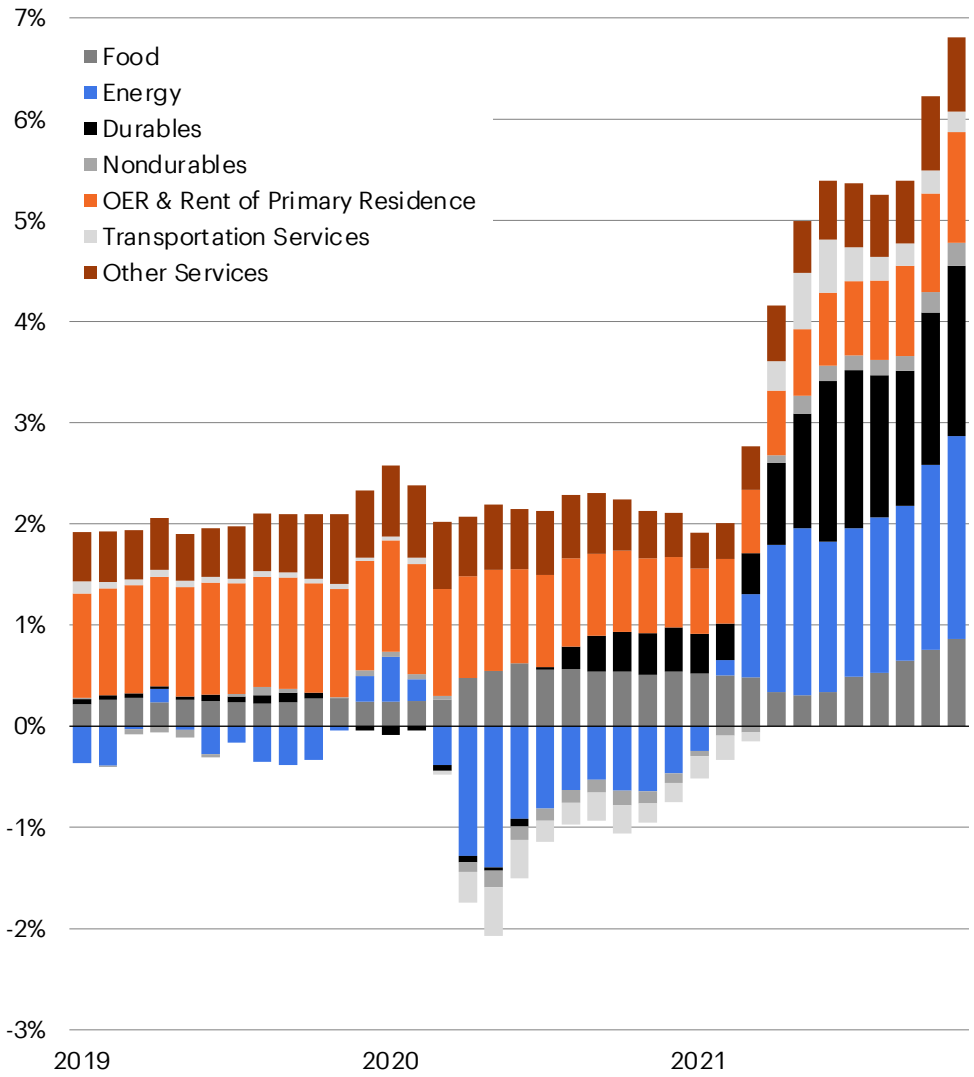
10 for '22

We expect 2022 to be a year of solid growth but surging inflation and policy headwinds. We break down where to find value, growth and returns.

1. Inflation
2. Household consumption
3. Labor, wages & growth
4. China
5. Fed policy
6. Energy
7. Crypto
8. Credit markets
9. Equities
10. Inflation is coming for the 60/40 portfolio

1 Inflation!

Contribution to CPI by category, %y/y



Source: Department of Labor, NBER. Shaded areas represent NBER-dated recessions.

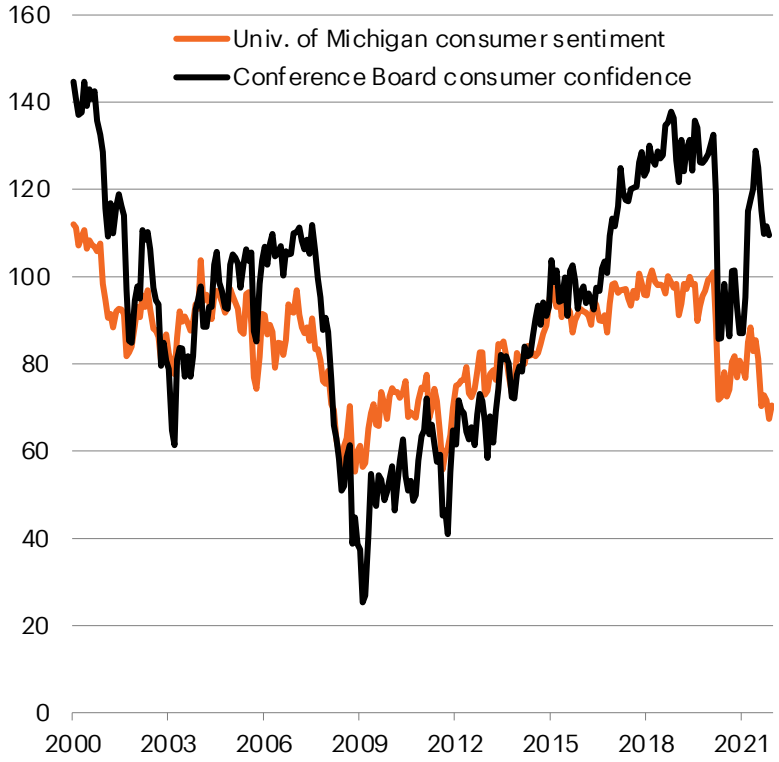
Inflation will likely dominate headlines for much of 2022. And with good reason: After being relatively stable around 2% for 25 years, inflation has erupted from virtually every corner of our economy. Driven by commodity price pressure, supply-shocks, higher wages and strong demand, inflation is now the highest since 1982.

Some of these factors may ease. Oil prices more than doubled from Q3 2020 to Q3 2021 but have fallen 17% from their October peak. There is early evidence that supply bottlenecks are lessening, which could help the supply-demand mismatch. But concerns that inflation could remain elevated are justified. Wages are persistently higher in the face of a labor shortage and are driving up the cost of goods and services. Owners' equivalent rent, the cost of shelter, is likely to rise as rents continue to increase. Inflation could look worse before it looks better, and we expect inflation to continue to rise in Q1 2022 before decelerating to 3.5% by end-2022, still well above pre-pandemic levels.

Inflation poses the single biggest challenge to the economy, investors and policymakers.

2 Households still driving growth, with ample fuel in the tank

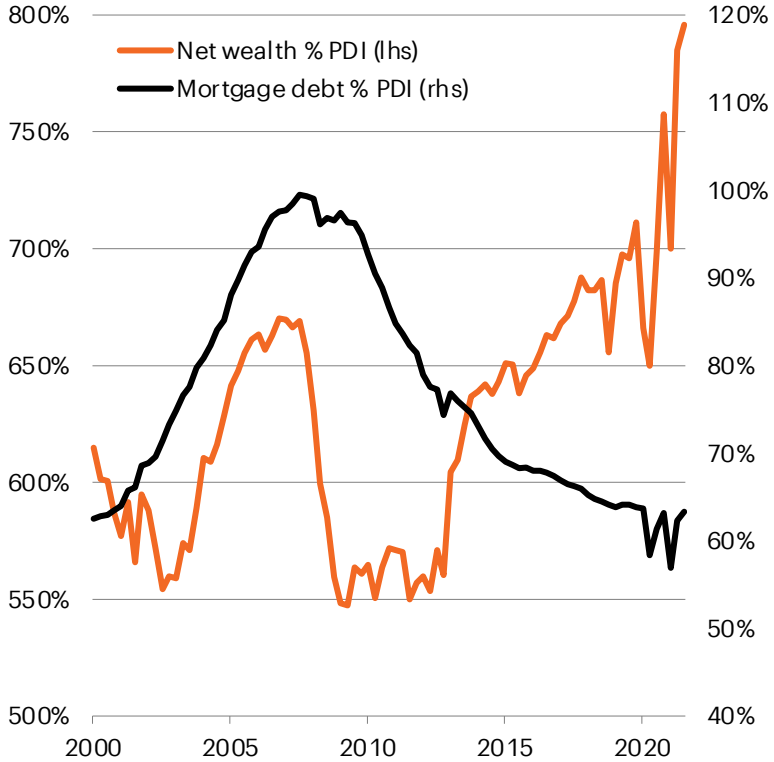
Consumer confidence at top of watch list



Source: Macrobond, as of December 15, 2021.

The consumer had a blowout year in 2021, posting double-digit growth in the first half of the year, and driving overall GDP to growth far above its long-run potential. In 2022, as excess savings from COVID-related policies fades, the outlook for consumption remains healthy but more moderate. Consumer confidence is at the top of our watchlist. Inflation has emerged as a concern for consumers, as reflected in the University of Michigan consumer sentiment number, which recently slumped below the 2020 low in the acute phase of the pandemic. On the upside, households face strong labor prospects, which traditionally support consumer confidence.

Household finances, % personal disposable income

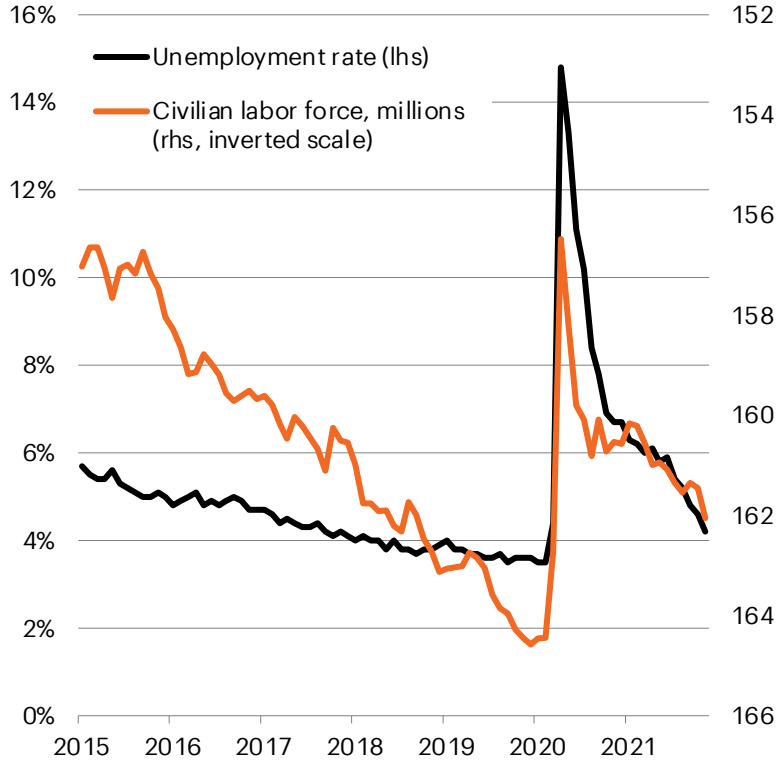


Source: Flow of funds, FS Investments, as of December 15, 2021.

The consumer enters 2022 in a strong financial position, as well, which should continue to power strong demand. Massive fiscal stimulus as well as pandemic-driven changes in consumption helped households amass significant savings. While excess savings lingers, it is fading fastest in the lowest income quartile. Similarly, wealth gains have been concentrated at the top quartile. But even in the face of surging home prices, households have managed leverage responsibly. Looking ahead, there is room for households to bolster spending by leveraging home equity and continuing to draw down savings.

3 Look beyond the unemployment rate

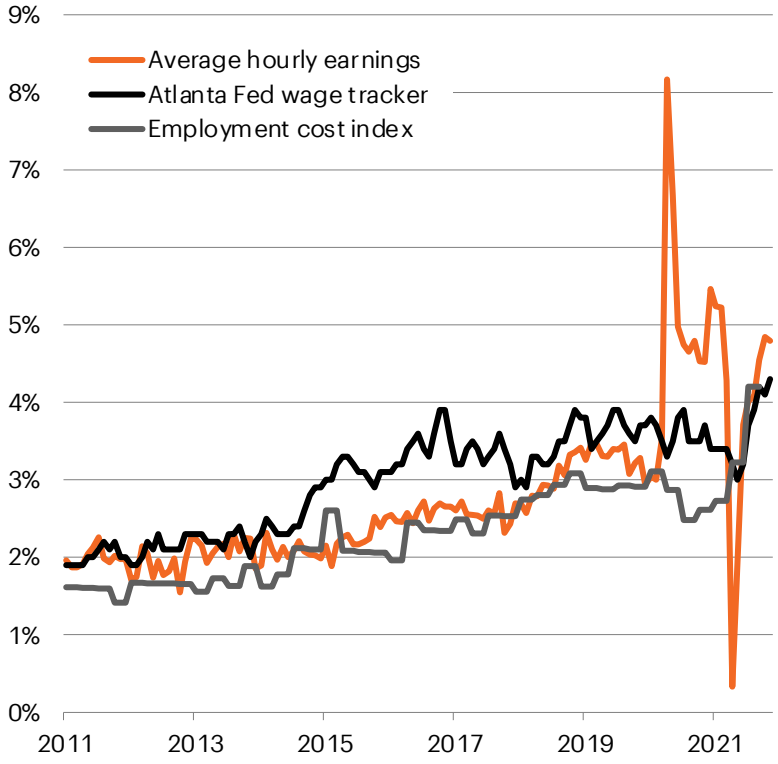
Jobless rate driven partly by labor force dynamics



Source: Bureau of Economic Analysis, NBER. Shaded areas represent NBER-dated recessions.

The labor force will likely remain red-hot in 2022, as the demand for workers runs up against demographics and a gradual (and only partial) recovery in labor force participation. The unemployment rate starts 2022 just above 4%, a historically low measure. But this one number masks the fact that jobs recovery remains far from complete, and the size of the labor force is 2.4 million smaller than before the pandemic. Almost a million is due to retirement, but workers of all ages have left the labor force, as well. We expect job growth to continue to be robust in 2022, but the more moderate than the blockbuster 555,000 average monthly gains of last year.

Wages are rising, % y/y

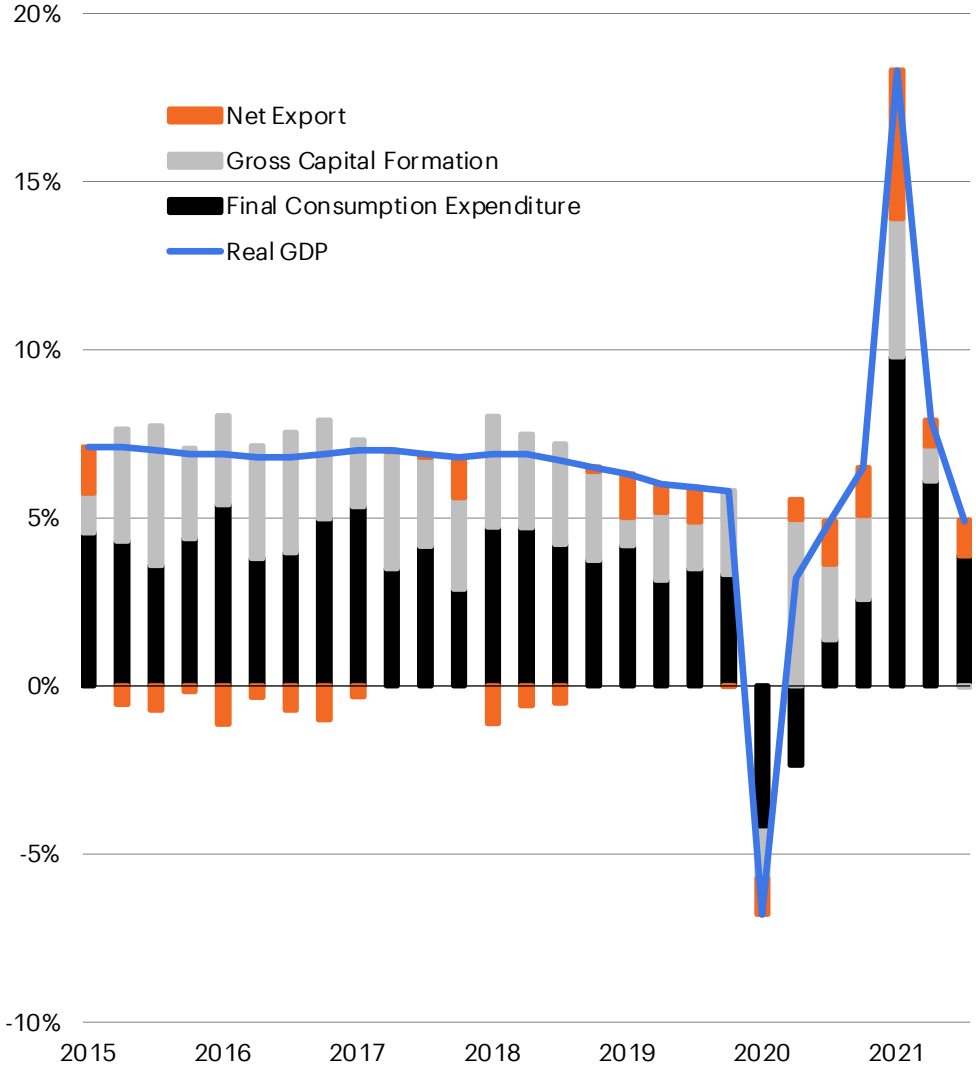


Source: Bureau of Labor Statistics, Federal Reserve Bank of Atlanta, as of December 20, 2021.

This likely means that upward pressure on wages will continue. Measures of wage growth have accelerated, with particularly notable wage gains in lower-income categories of service workers (leisure & hospitality, transportation). This is a piece of the inflation picture the Fed will be closely tracking. In 2022, higher wages may convince some people to reenter the work force, but we expect this to be a gradual process and do not look for a complete rebound of the labor force in 2022 (or, for that matter, in 2023). Over the long run, declining labor force growth will put downward pressure on our economy's potential growth rate, shining a spotlight on needed productivity gains to fill the gap.

4 China: Slower growth may call for strong policy support

Sector contributions to real GDP



Source: Federal Reserve, NBER, Macrobond, as of December 10, 2021. Shaded areas represent NBER dated recessions.

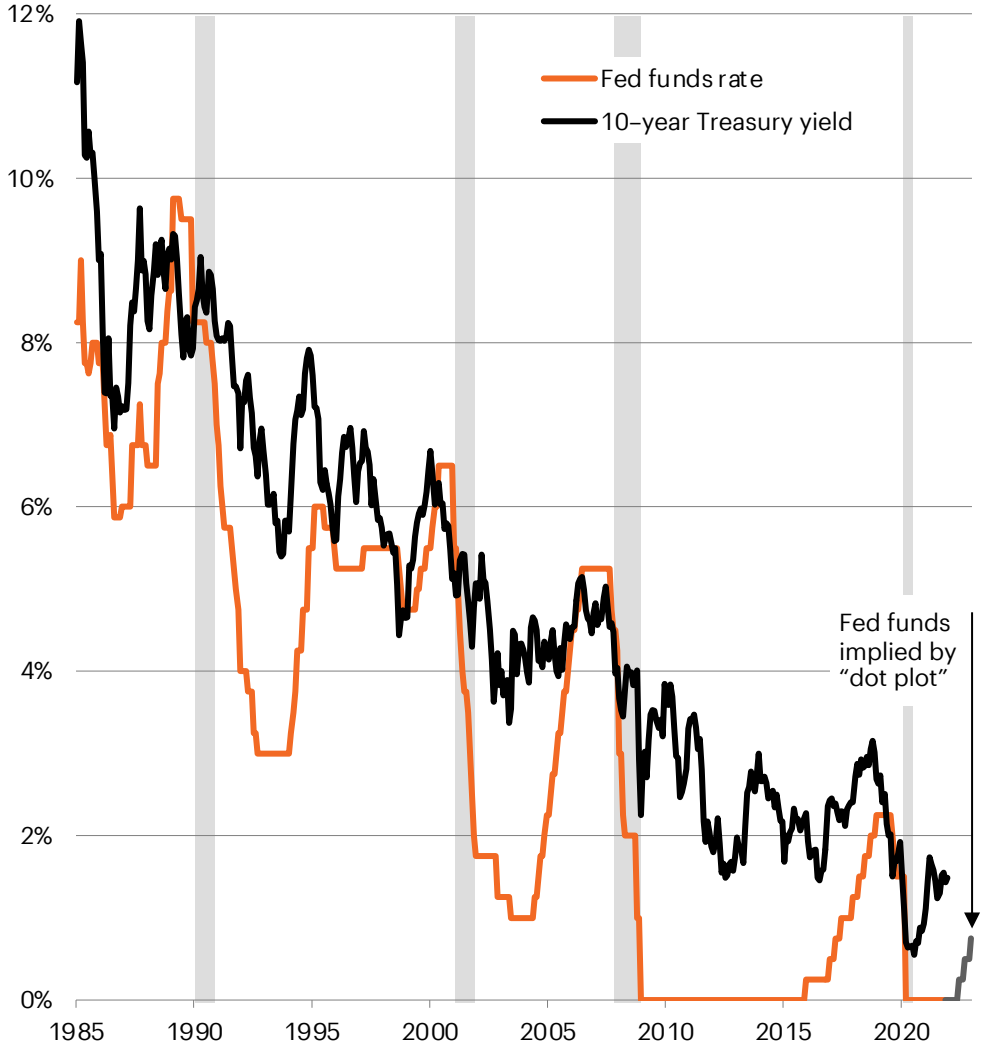
China's economy slowed sharply in 2021 against the backdrop of deep crackdowns, especially in the tech and property sectors, and a slowdown in credit formation. Industrial production has been weak, and consumption has been impacted by continued COVID-related shutdowns. Exports have been a strong positive contributor to growth over the past 18 months. Looking ahead, a challenge to China's economy could be slower U.S. growth, meaning a greater reliance on domestic demand.

On December 6, China's monetary authority cut the reserve requirement ratio by 50bps to 8.4% to release capital into the financial system as a way to stimulate the economy. In contrast to other major central banks, China is embarking on an easing cycle. One wild card in 2022 could be China's management of the COVID-19 pandemic, and its zero tolerance for cases, which is likely not sustainable in the very long run. We would not expect any changes until after the Olympics, but China may rethink the draconian shutdowns in the face of new cases.

China has signaled the start of a monetary easing cycle, in contrast to other major central banks.

5 Mythbusting interest rate reaction to a Fed tightening cycle

Policy and long-term yields across business cycles



Source: Federal Reserve, NBER, Macrobond, as of December 10, 2021. Shaded areas represent NBER dated recessions. Fed funds rate projection implied by December 14, 2021, Fed Economic Projections.

Monetary policy will look completely different in 2022 as the Fed rapidly tapers the emergency quantitative easing put in place during the pandemic and embarks on a rate hike cycle. The Fed is on track to end its taper by mid-March, opening the door to a possible rate hike at the March 15–16 meeting. So far, markets have easily priced in 75 bps of rate hikes in 2022, and over 5 rate hikes more than the next two years, while continuing to break record highs. However, the path of Fed policy next year is highly uncertain. Should inflation continue to surprise to the upside and wage growth accelerates further, the Fed may decide to move more rapidly. Put another way, should the market experience volatility in the face of Fed rate hikes, policymakers may be less likely to capitulate (a la 2018), because the Fed will view managing inflation as an overriding objective.

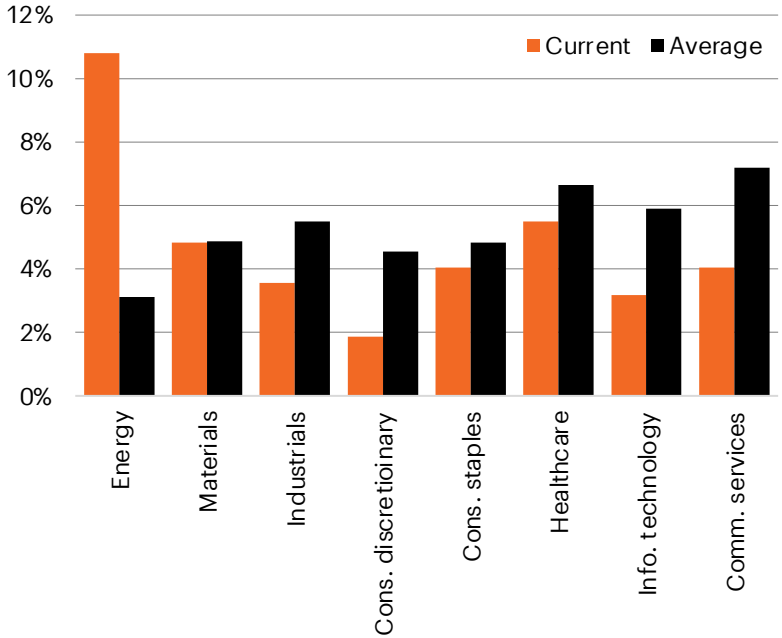
Against this backdrop, we buck the consensus and still expect long-term interest rates to remain near historic lows. We see a 1.50–2.00% range dominating for much of next year, with the possibility of rates moving to 2.00–2.50% toward end-2022. Long-term rates typically rise somewhat during a Fed rate hike cycle, but the move higher can quickly be offset by concerns that rate hikes will slow long-term growth.

We expect long-term rates to remain below 2% for much of 2022.

6 Energy: Transition brings opportunity

Energy valuations appear attractive

Free cash flow yield
S&P 500 sectors

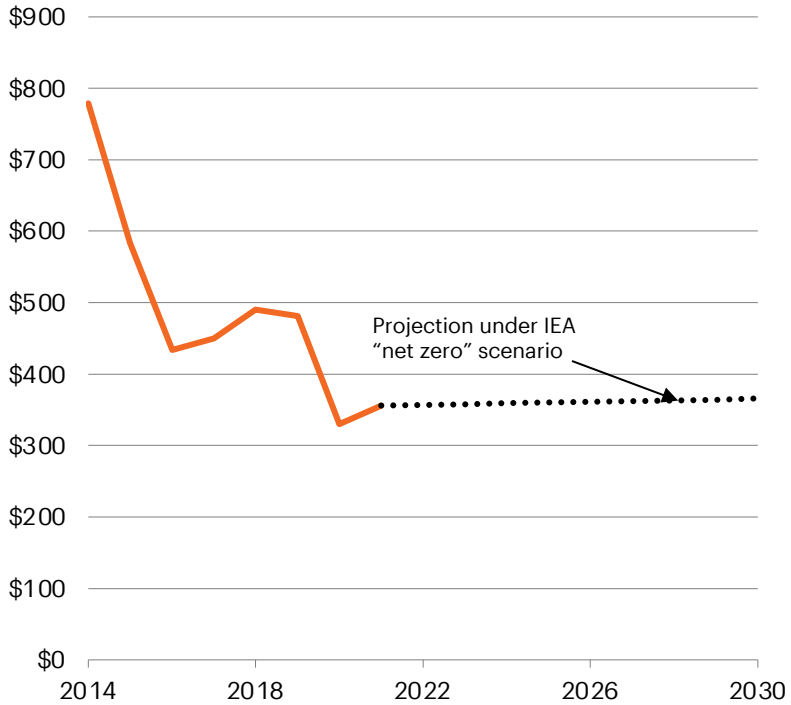


Source: Bloomberg Finance L.P., as of December 15, 2021. Excludes financials, utilities and real estate, for which free cash flow is not a meaningful statistic. Average represents the average sector free cash flow yield since January 2010.

By any account, it has been a remarkable year for energy stocks—S&P 500 Energy has risen 48% in 2021, an index high and on track to be the best year in the sector's history. Oil prices eclipsed $80/bbl for the first time since 2014, and natural gas prices rose to a decade high. Yet energy remains the worst performing sector in the index since January 1, 2020, having gained only 1%. In other words, despite all the changes wrought by the COVID pandemic, markets are assigning the same value to the U.S. energy sector now as they were pre-COVID. Are there any catalysts for energy's continued outperformance, or will 2021 be seen as just a brief respite in the inevitable decline of the old energy sector?

Global oil & gas capital spending

$ billions



Source: International Energy Agency, "World Energy Outlook 2021".

The pandemic has acted as an accelerant for fossil fuel companies embracing capital discipline. Forecasts for energy sector capex have been cut by a third over the past two years which, combined with higher commodity prices, has resulted in impressive free cash flow generation. In fact, energy is the only sector in the S&P 500 trading cheaper than its historical average. Of course, the energy transition looms over the sector's terminal value, and an increasing number of investors are unwilling to provide capital to polluters. This could set up a scenario in which oil and gas prices remain elevated and volatile as supply of fossil fuels is constrained more rapidly than demand, creating a provocative opportunity for sector winners to produce significant cash flow for years to come.

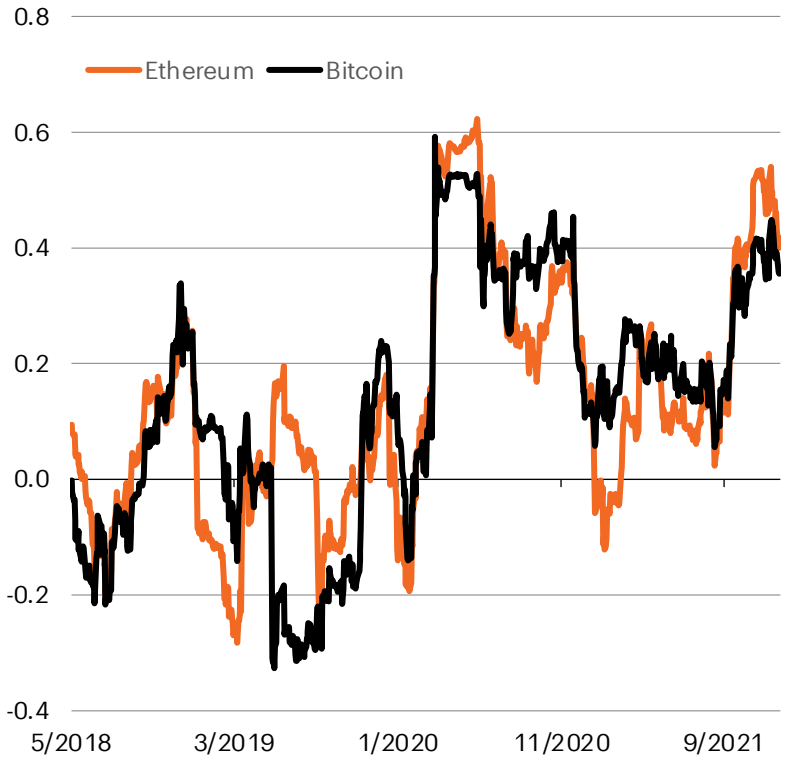
7 The institutionalization of crypto continues

Cryptocurrency sector market cap

Source: Macrobond, Coinmarketcap.com, as of December 30, 2021.

Cryptocurrencies will continue to be a focus in 2022 as the size of the market grows and the institutionalization of the asset class will become more entrenched. Increasingly, regulators are entering the fray, and the coming year may see government agencies look to regulate the cryptocurrency trading platforms that are a part of the transaction. There continues to be wide-ranging discussion of whether cryptocurrency qualifies as a security and should be under the purview of the SEC or whether, as a money transmission service, regulation should come from the states.

Rolling 60-day correlation to S&P 500



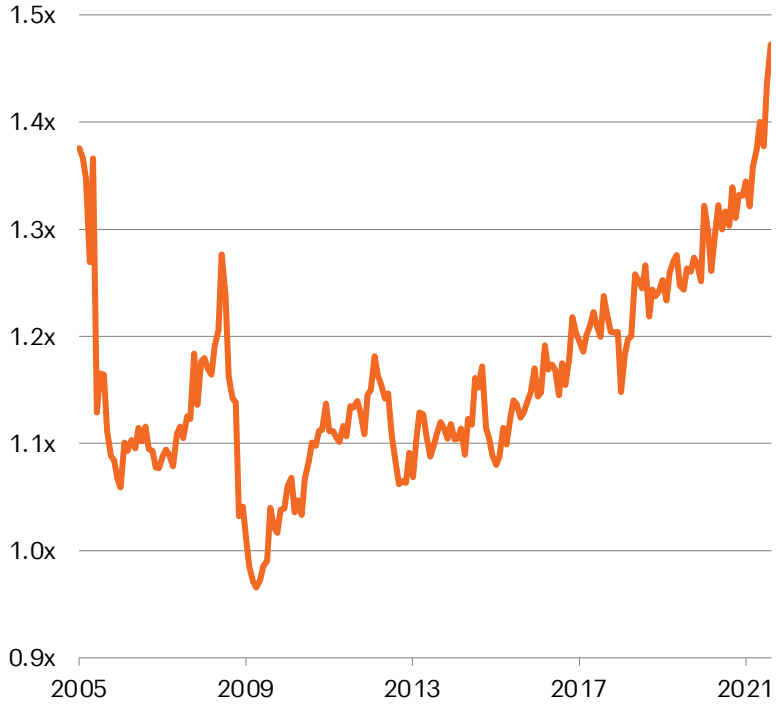
Source: Bloomberg Finance L.P., FS Investments, as of December 30, 2021.

Cryptocurrencies saw higher correlation to equity markets and are increasingly tied to tech indices that often trade alongside riskier assets. Crypto's value proposition as a store of value in a high inflation environment is also being tested – like gold, bitcoin has experienced significant sell offs, but it has also showed signs of reacting positively to upside surprises in CPI. Overall, it was a solid year for the largest crypto assets, with bitcoin rising 60% and ether up 400%, and the year also included exponential growth in many new, exciting projects. As the crypto market exits its infancy and becomes more entrenched in financial markets, its correlation to traditional assets must be watched closely; however, we continue to view it as an intriguing space for diversification and growth.

8 Equities: Valuations could test U.S. outperformance

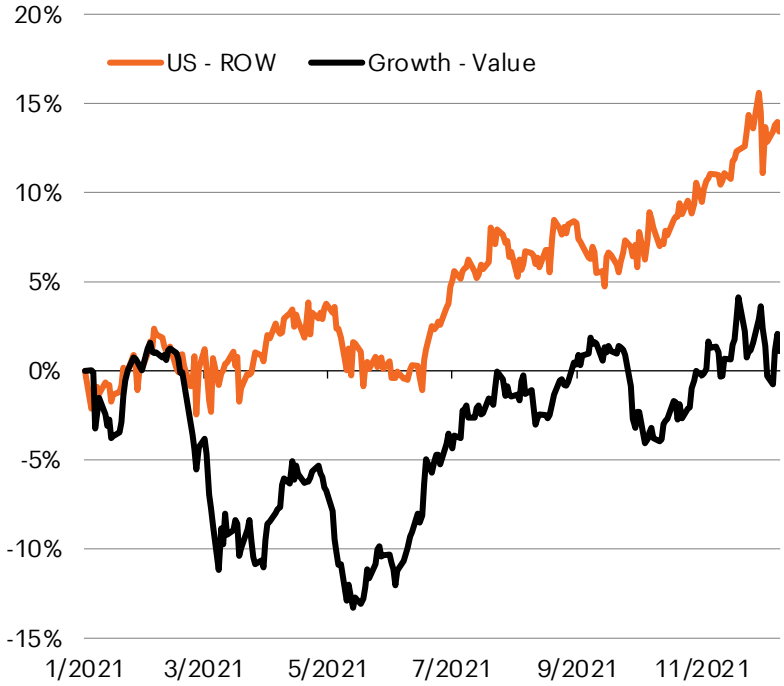
Relative valuations

Fwd. P/E, ratio of U.S. vs rest of world



Source: Bloomberg Finance L.P., as of November 30, 2021. MSCI USA Index and MSCI World ex-United States Index.

Global relative performance, 2021 YTD



Source: Bloomberg Finance L.P., as of December 9, 2021. "US-ROW" represents relative performance of the U.S. (MSCI USA Index) vs. the rest of the world (MSCI World ex-US Index). Growth-Value represents the relative performance of Growth stocks (MSCI World Growth Index) vs. Value stocks (MSCI World Value Index).

One of the primary storylines in equity markets over the past decade has been the seemingly impenetrable leadership of U.S. markets. Heading into 2020, U.S. stocks had outperformed both EMs and other developed markets in 7 of the preceding 9 years. Then, in 2020 and 2021, amid the pandemic and rapid economic rebound, the S&P 500 beat other DMs and EMs by a combined 29% and 32%, respectively. The experience of the last two years has investors asking, is there any environment in which U.S. markets underperform? While we remain generally positive on U.S. markets, we do believe there is a case to made that 2022 could usher in that environment.

First, the valuation premium being assigned to U.S. stocks is the highest it has been since the early 2000s. Compared to the rest of the world, the U.S. forward P/E ratio is nearly 1.5 times higher. Second, the growth stock-dominated U.S. markets have become heavily reliant on changes in rates; relative performance of the U.S. vs. the rest of the world has a 0.36 correlation with changes in the shape of the yield curve (flatter = U.S. leads) over the past year, versus a historically negligible correlation. Should the recent curve flattening prove overdone, U.S. markets could lag. Finally, relative economic fundamentals could even out, with growth and earnings in places like Europe and EMs beginning to catch up.

9 Macro fundamentals support narrow credit spreads in 2022

Benign default environments historically correspond with tight spreads

Dates	Starting spread	Ending spread	Average spread	Average default rate
12/1994–7/1998	420	400	388	1.82%
12/2003–6/2007	445	307	358	1.73%
11/2010–3/2014	617	396	551	1.25%
12/2016–8/2018	439	360	378	1.76%
4/2021–present	345	348	338	1.40%

Source: ICE BofAML US High Yield Index, JP Morgan, FS Investments. As of November 30, 2021. Due to availability of data, December 1994–July 1998 data references Credit Suisse High Yield Bond Index.

Entering 2021, we called for credit spreads to test or surpass post Global Financial Crisis tights. High yield bond spreads did that—and then some. While senior secured loans failed to reach this threshold, they came close. Despite modest widening over the past few weeks, credit spreads are poised to enter 2022 in the top quartile in terms of valuation, prompting the question: Where can they go from here?

Consensus seems to be for modest spread widening over the next year, eroding what is likely to be a predominantly income-driven return in 2022. While we acknowledge that the various uncertainties facing markets—inflation, the timing of Fed rate hikes and COVID, to name a few—could cause some interim volatility, we maintain conviction that spreads in the HY market will average below 350bps next year and below 400bps for loans.

The backdrop for credit remains strong: Economic growth is likely to be above average, fundamentals continue to improve and default rates have plummeted. We remind readers that credit markets can—and have—traded in a tight spread range for years.

10 Higher inflation has come for the 60/40

Inflation shattered its 25-year range in 2021 and the outlook is still highly uncertain. For investors, even moderate inflation can negatively impact both the fixed income and equity allocations of a portfolio. For decades, investors have been harvesting both price and income gains from fixed income. Now, as the 10-year U.S. Treasury closes the year around 1.50%, inflation just below 7.00% y/y leaves real interest rates in deeply negative territory. This stands to erode traditional fixed income returns.

On the equity side, inflationary periods have historically not been an environment of easy returns. The combination of high inflation and a rising inflation environment has been the most challenging. As equity markets are increasingly concentrated into large cap growth stocks where valuations assume significant earnings in the future, higher inflation can heavily impact the present value of future earnings.

Inflation is something investors have not truly had to contend with in decades. In 2022, it should be a priority to recalibrate portfolios with the implications of higher inflation in mind.

Lara Rhame

Chief U.S. Economist, Managing Director

Lara is Chief U.S. Economist and Managing Director on the Investment Research team at FS Investments, where she analyzes developments in the global and U.S. economies and financial markets. Her fresh take on macroeconomic issues helps to inform and develop the firm's long-term views on the economy, investment trends and issues facing investors. Lara is committed to the Philadelphia community and serves on the boards of the Economy League of Greater Philadelphia, Hyperion Bank and Starr Garden Park.

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