Anticipation... Is Keepin' Me Waitin'

After reviewing the economic and market environment, FSA Investment Group and Highland offer the following comments on the current landscape:

Economic Update

The initial estimate from the Bureau of Economic Analysis (BEA) shows real GDP grew at an annualized rate of 6.9% in Q4 2021, easily beating expectations. That upside surprise, however, was mainly a function of a sizable build in non-farm business inventories, which added 4.9 percentage points to top-line growth. Absent inventory accumulation, Q4 real GDP growth was a more pedestrian 2.0%. For full-year 2021, real GDP grew by 5.7%, and while that is the largest yearly increase since 1984, it must be put in the context of the 3.4% decline in real GDP in 2020, the largest annual contraction on record.

While the rapid and wide spread of the Omicron variant weighed on economic activity – restaurant traffic, air travel, lodging, entertainment, and recreation venues – in January, one would be hard-pressed to find evidence of that in the headline numbers from the top-tier economic data reports for January released thus far. Indeed, the Q4 GDP report set the tone for the top-tier economic data for the month of January – i.e., lofty headline numbers overstating the case – and we expect that pattern to hold as additional January economic data reports come out over the course of this month. For instance, the BEA reports unit motor vehicle sales jumped to an annual rate of 15.041 million units in January, up from December's sales rate of 12.540 million units. The not-seasonally-adjusted data, however, show unit motor vehicle sales fell by 17.7% in January, and while that may seem like a large decline, it is actually quite a bit smaller than the typical January decline of closer to 30%, which is what the seasonal adjustment factors were geared for. The result is a headline sales number – seasonally adjusted and annualized – that made January vehicle sales look far better than was actually the case.

The same effects were, well, at work in the January employment report. Total non-farm employment rose by 467,000 jobs in January, topping expectations that were all over the map, with forecasts ranging from a loss of 400,000 jobs to a gain of 250,000 jobs. Our forecast called for an increase of 138,000 jobs, but that was mainly a function of what we expected to be generous seasonal adjustment, which is standard fare for the month of January. To that point, the not-seasonally-adjusted data show total non-farm employment fell by 2.824 million jobs in January, a decline of 1.9% from December. This is a bit smaller than the average January decline of 2.1% over the 2000–2021 period, and this January's seasonal adjustment factor was more generous than has been typical for the month, thus yielding a seasonally adjusted job growth number that embarrassed forecasters, even if in a good way.

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FSA Investment Group does this with the highest levels of trust, integrity and respect while always collaborating using a team approach. We are dedicated to professionally supporting, educating, and providing informed direction to each and every client.

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Favorable seasonal adjustment also flattered the results of the monthly surveys of the manufacturing and services sectors conducted by the Institute for Supply Management (ISM). The ISM Manufacturing Index fell to 57.6% in January, its lowest level since September 2020 but nonetheless the 20th consecutive month above the 50.0% break between contraction and expansion. Along the same lines, the ISM Non-Manufacturing Index fell to 59.9% in January, indicating a 20th consecutive month of expansion in the broader services sector.

Two things from the ISM's January surveys stood out to us, the first being the extent to which survey respondents expressed continued frustrations over labor supply. Firms are not only having difficulty finding additional workers to hire, but they are also having trouble retaining their current workers, and while it may not have turned up in the BLS's January employment report, the ISM's January surveys suggest the spread of the Omicron variant compounded ongoing labor supply issues. The other detail from the ISM's January surveys that struck us is that price pressures for non-labor inputs show few, if any, signs of abating. Of the combined 36 industry groups represented in the ISM's two monthly surveys, 35 reported paying higher prices for non-labor inputs in January, and in each of the past 13 months at least 34 of the 36 industry groups have reported paying higher prices for inputs.

Note that the ISM's surveys reflect month-to-month changes, so input costs in a given month are not being compared to some fixed point in time. In other words, firms have faced month after month after month of higher input costs, which combined with higher costs for labor and shipping have posed ongoing threats to profit margins. Thus far, however, firms have been able to exercise considerable pricing power, passing along these higher costs to their customers in the form of higher prices. On the retail level, inflation as measured by the Consumer Price Index (CPI) hit 7.0% in December 2021 and then accelerated to 7.5% in January. It remains to be seen whether, or to what extent, firms will be able to sustain this pricing power. To be sure, an easing of global supply chain and logistics bottlenecks will alleviate, if not reverse, upward pressure on goods prices, but faster growth in services prices and continued robust wage growth will sustain inflation above the FOMC's 2.0% target through year-end.

Although not implementing any policy changes at their January meeting, the FOMC did lay the groundwork to begin raising the Fed funds rate at their March meeting, which is when the next set of updated economic and financial projections of committee members will be released. Expectations among market participants are for there to be between four and seven 25-basis-point Fed funds rate hikes in 2022, and in the wake of the January employment report many inserted additional rate hikes into their forecasts, with many predicting that the March meeting will bring a 50-basis-point hike. One thing that strikes us, however, is that market participants are reacting to headline numbers that have been made to look more favorable by generous seasonal adjustment. It remains to be seen whether the FOMC will do the same. At least for now, we continue to expect the FOMC to raise the funds rate in 25-basis-point increments with no more than five rate hikes in 2022.

Investment Strategy Update

The Highland Investment Working Group remains constructive on equity and equity-like assets and less sanguine on traditional fixed income investments. Despite recent volatility and near-term economic headwinds, the long-term outlook for growth remains high. Our Highland Diffusion Index (HDI) continues to support this view. The HDI shows the following:

- Financial condition indicators are mixed, as credit spreads have begun to widen and equity market momentum has begun to slow.
- Monetary policy remains accommodative, although increases in the Federal Funds rate are on the horizon.
- The economic and employment pillars of our HDI framework continue to point toward growth.

Positioning for Inflation

Positioning within traditional asset classes has not materially changed since last month. The team continues to overweight U.S. equity exposure relative to emerging markets, as U.S. firms' profitability is generally not as sensitive to interest rates. Of course, the threat of rising rates has exerted significant downward pressure on price multiples for U.S. stocks, with high-flying growth stocks hit particularly hard; for the month of January, EM stocks actually outperformed U.S. stocks by over 300 basis points.

Relatedly, we continue to favor small-cap value stocks within the U.S., due largely to their cyclical sensitivity and diversification benefits. In January, the Russell 2000 Value Index held a combined 53% in economically sensitive sectors, including financials, industrials, energy, and materials; conversely, the S&P 500 index had just 25% collectively allocated to these sectors. To the extent that equity market leadership is changing to reflect new economic realities of tighter monetary policy and higher inflation, we feel that clients will be well served by limiting exposure to yesterday's winners.

On the fixed income front, we continue to overweight non-core assets and underweight traditional sectors such as Treasuries, agency mortgages, and corporate credit. Non-core credit remains attractive relative to core credit due to the lower duration and potentially more insulation from rising rates offered by spread sectors. While an overweight in structured credit has been highlighted as one specific area within non-core credit where we have high conviction, the case for structured credit as a bright spot over and above other areas is becoming less compelling as spreads continue to grind tighter.

Outside of these traditional asset classes, the team has been increasingly active in real assets over the past few quarters. Our conviction in private real estate is broad-based, supported by both general growth sensitivity and inflation-hedging characteristics, as well as historically robust fundamentals in most sectors and regions. Broadly speaking, private real estate boasts a strong performance record during periods of rising inflation and rising interest rates. Beginning with inflation, from 1978 through 2020, private real estate returned 13.2% annualized on average during regimes when both real GDP growth rates and inflation rates were in their highest quartile historically. More moderate economic growth and inflation have also favored real estate; during periods from 1978 through 2020 when both real GDP growth rates and inflation rates were either second or third quartile, private real estate returned 9.1% annualized on average. Regarding interest rates, private real estate has performed admirably in prior periods of steep increases in 10-year Treasury yields, as illustrated below:

Private Real Estate Performance During Rising 10-Year Regimes

Starting Date	Starting Yield	Ending Date	Ending Yield	PRE Annualized Return
Q279	8.8%	Q180	12.6%	22.50%
Q280	10.1%	Q381	15.8%	15.40%
Q482	10.4%	Q284	13.8%	13.20%
Q486	7.2%	Q387	9.6%	7.90%
Q393	5.4%	Q494	7.8%	4.80%
Q398	4.4%	Q499	6.5%	12.50%
Q203	3.5%	Q206	5.2%	15.20%
Q216	1.5%	Q318	3.1%	7.20%

Source: Bloomberg, Federal Reserve Bank of St. Louis, NCREIF, Clarion Partners Investment Research

This strength generally owes to commercial real estate's high correlation to economic activity and the ability to leverage multiple growth drivers in a dynamic economy.

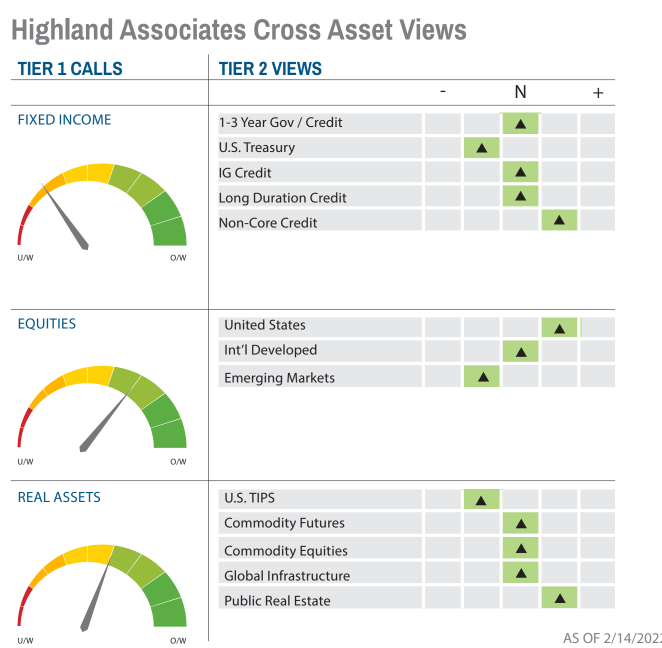
Which brings us to fundamentals. The core four property types – industrials, multifamily, office, and retail – are capturing a variety of economic trends with varying degrees of success. Industrial and multifamily properties are supported by historically strong supply/demand imbalances and continue to draw the interest of investors, while office and retail properties have struggled to recover amid COVID challenges and changing consumer tastes. Specifically on industrials, this property type has benefited immensely from the COVID-driven acceleration in e-commerce sales, which grew by 40% in 2020 alone. While this rate of growth is not sustainable, economists still expect e-commerce sales to grow in the double digits for the foreseeable future. Investment in the industrial market has been quite strong but remains far behind the surging demand for warehouse space. Specifically, net absorption (a proxy for incremental demand/physical occupation of property) for industrial real estate totaled 292 million square feet for the first nine months of 2021, while new supply was just 193 million square feet. This has led to a historically low vacancy rate of just 3.6% and rent increases of up to 40% in some locations.

Looking longer term, a general rule of thumb is that each $1 billion of new e-commerce sales requires 1 million square feet of new warehousing; given that background, investors should have confidence that industrial leadership has plenty of room to run. Multifamily also appears poised to benefit from a significant dislocation in available supply. Specifically, the national average occupancy rate for all U.S. apartments rose from 95% at the end of 2020 to an all-time high of 97.5% at the end of 2021. In the current context, demand for multifamily grew by nearly 400,000 units to a new record of 674,000 units. In the longer term, these imbalances appear set to continue, as years of underinvestment following the Global Financial Crisis have generated a U.S. housing shortage of 3–5 million units. At the same time, household formation among the millennial generation will remain a persistent source of demand for several years to come.

Conversely, office and retail property types are exhibiting weaker fundamentals. Within office, there remains a great deal of uncertainty around the future of remote or hybrid work solutions. However, real estate fund managers are quick to point out that demographic and population shifts present far more attractive prospects for office space in second-tier markets in the South and West, while acknowledging that trophy properties in major U.S. metros likely leave little room for upside. Interestingly, as a point of differentiation, some real estate investors have begun building custom app and concierge services at the property level to drive value to tenants. This is an indication of a very competitive market, but opportunities are clearly available. Regarding retail, malls and shopping centers have suffered at the hands of gains made in e-commerce and industrial properties. As a result, many managers have chosen to underweight this sector in favor of non-core assets like life sciences and self-storage.

Our diversified managers are generally overweight stronger fundamental sectors such as industrial and multifamily and underweight office and retail; most diversified managers also have material allocations to non-core assets like life sciences, self-storage, and media/content. For investors worried about rising costs for labor and construction materials, core funds with limited emphasis on new development represent an excellent hedge. For those who believe such pressures are unlikely to be sustainable beyond the near term, they may access real estate funds with a greater emphasis on new construction and development.

As a whole, private real estate returned roughly 22% last year, its best 12-month period since 1979. Despite recent strength, our conviction in the asset class remains high. Last year's gains were driven largely by appreciation, as purchase and sale transactions began to more accurately reflect the remarkable supply/demand imbalances we previously noted. We believe that this adjustment is simultaneously long overdue and incomplete, and we expect more and more investors to place dollars into this relatively low volatility, cash flow-driven space. At the same time, growth in rents should continue to drive strong income returns for investors. We've spoken with several managers who reported double digit rent increases last year, while also noting that rents for the entirety of their portfolios remain as much as 30%–40% below current market rents. This sets the stage well for a sustained rally in private real estate going forward.



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