

COVID Conundrum

“The best laid plans of mice and men often go awry.”
– “To a Mouse” by Robert Burns (1786)

For all the joyfulness and positivity that Thanksgiving brings, the end of this November also brought with it headlines of a new COVID variant named Omicron – the 15th letter of the Greek alphabet – which the WHO chose by leaping over the prior two in line to reportedly avoid confusion (“Nu” sounds too much like “new”) and politics (“Xi” is also the first name of China’s leader Xi Jinping).

A sell-off in risk assets occurred the day the news broke – which happened to be the Friday after Thanksgiving – an abbreviated trading session that’s traditionally not very exciting. Markets were shook as Omicron raised concerns of a more transmissible and severe strain that would be more resistant to vaccine effectiveness.

While its much too early for anyone to draw definitive conclusions – and make no mistake we aren’t epidemiologists – we thought it might be helpful to frame up the conversation. Here’s what we know so far.

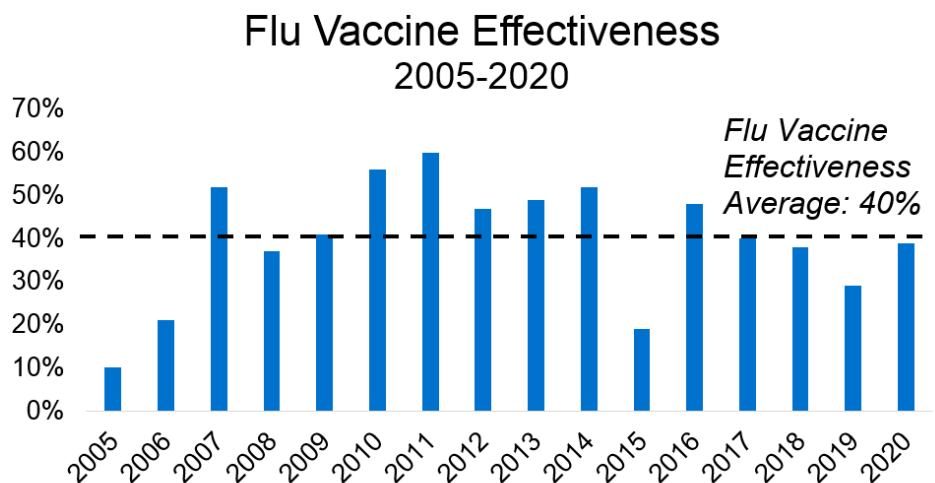
- The WHO deemed Omicron (B.1.1.529) a variant of concern (VOC) because it has more than thirty mutations to the spike protein that could make it more elusive for the existing vaccines/antibody treatments, more transmissible and/or more virulent.
- The strain was initially identified in South Africa with cases now being found in other countries across 6 continents.
- Reports from the epicenter of this strain (South Africa) suggest that it is more transmissible than the Delta variant but may be less severe. Symptoms from cases that have been reported there have been described as “mild” though many of these cases were generally in younger people (less than 5% of the population is over 60).
- Moderna and Pfizer have said they can produce a tailored batch of vaccines/boosters for Omicron ready for distribution in early 2022 (90-100 days), subject to regulatory approval.
- A number of countries have reimposed travel restrictions (including the US, EU, UK, Japan and Canada) in response but haven’t gone so far as to initiate lockdowns.

So what do we make of all of this? In our view, there are two extreme scenarios with degrees of magnitude in between.

Scenario 1: The more positive outcome might lead to a new dominant but less severe variant that competes away the Delta strain. With the addition of updated vaccines and/or boosters, this would lead to a more mild path for a COVID endemic and the continuation of economic reopening.

Scenario 2: The more negative outcome points to a COVID strain that is both more transmissible and severe and where vaccines prove ineffective. Such a scenario might lead to countries reimposing economic shutdowns in a repeat of the early pandemic days.

While we don't know which path COVID will take, we thought it was a helpful reminder to look back at flu vaccine effectiveness over the last 16 years. It varies from year to



Source: CDC.gov; CDC calculates vaccine effectiveness estimates through the US Flu VE Network.

year, but an average effective rate of 40% suggests the COVID vaccine(s) (with initial effective rates of 90%+) has a lot of cushion before rendered ineffective. As a result, its hard to see an environment that takes us back to the early days of 2020. Vaccines and therapeutics suggest we are in a different spot as has learning from the costs and unintended consequences of economic lockdowns.

In the interim, the market will be left to deal with the uncertainty of it all. The first scenario means a world with more (relative) normality and a greater focus on the natural evolution of market and economic cycles. We'd anchor back to our 2022 outlook in which growth moderates but stays resilient. The second scenario points to an environment that resembles more of the early days of the pandemic where growth becomes increasingly scarce and the market increasingly narrow. Initially, this might be stagflationary with further supply chain disruptions but, ultimately, turn deflationary as demand slows materially without more fiscal stimulus.

It's almost impossible to predict the evolution of a virus and there is great debate over whether this one will be rendered with an "evolution gentling" or not. For much of this year, leadership was more cyclical in tone and credit was benign with rates on an upward trajectory. These trends will be important signposts to determine to what extent things have changed. We'll be keeping our head on a swivel and reassessing as the data evolves.

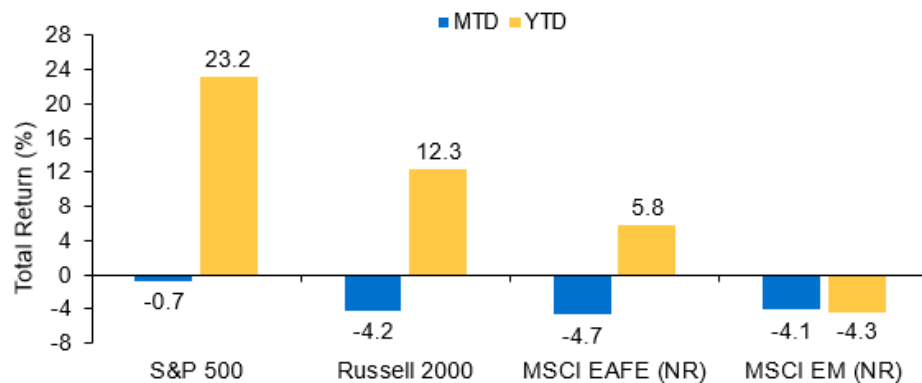
The combination of Fed policy uncertainty and the COVID conundrum put a damper on risk assets in November. Still, full year returns have indicated a reflationary bias. Real Assets outperformed Stocks and Stocks outperformed Bonds. Commodities, Real Estate, and Cyclical sectors did the best while interest rate sensitive Bonds suffered the most.

Stocks

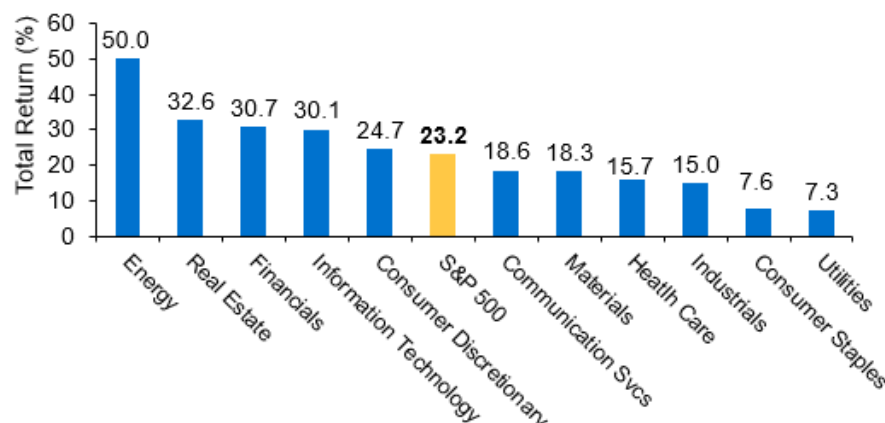
Stocks traded lower in November though full year returns remained mostly strong. Domestic stocks (S&P 500 and Russell 2000) outperformed

international stocks (MSCI EAFE and MSCI EM) – especially the Emerging Market region where a broadening regulatory crackdown in China embroiled markets. Policymakers there have taken a hardened stance on everything from education to technology to real estate. Increased regulations have become China’s answer to solving for income equality and self sufficiency. Year-to-date, all S&P 500 sectors have posted positive returns. Given robust corporate profit growth, sectors have reflected an investor preference for Cyclical exposure with significant outperformance in Energy and Financials (Cyclical Value) as well as Technology and Consumer Discretionary (Cyclical Growth). Conversely, more traditional Defensives (Health Care, Utilities, Staples) have lagged. In November, markets narrowed with only two sectors offering positive returns (Tech and Discretionary) as investors flocked to US Large Cap Growth stocks.

Global Equity Returns
November 2021



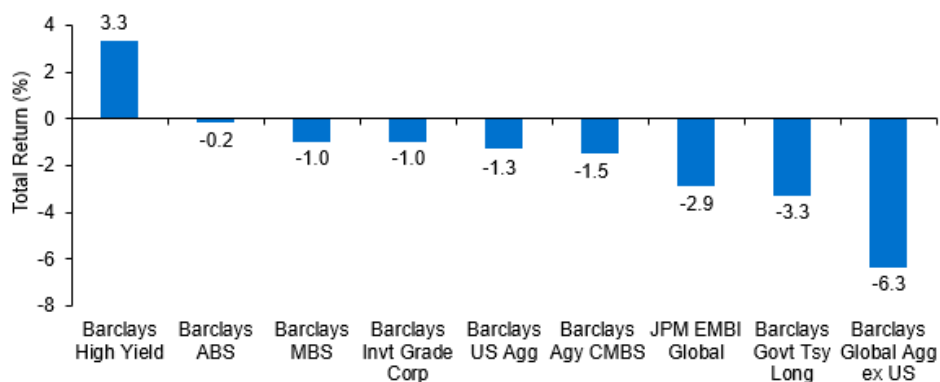
S&P 500 Sector Returns
November 2021 - YTD



Bonds

Bond returns have been mostly negative year-to-date amid an upward rate bias. Long-term interest rates began trending higher last August, though they've moved sideways since April with a downward bias to end the month. While shorter term rates stayed mostly anchored by a Fed on hold, they began to move up more notably in October pricing in a removal of policy accommodations. Credit spreads have been benign for much of this year but started to leak wider in November. Year-to-date, a stronger dollar pressured International Fixed Income (Global Agg ex US) for the balance of the year while the more interest rate sensitive areas of the bond market were negatively impacted by higher rates (Govt Tsy Long). Meanwhile, securities with shorter durations and more sensitivity to equities outperformed, including High Yield and Investment Grade corporate bonds as well as Securitized Assets (ABS, MBS).

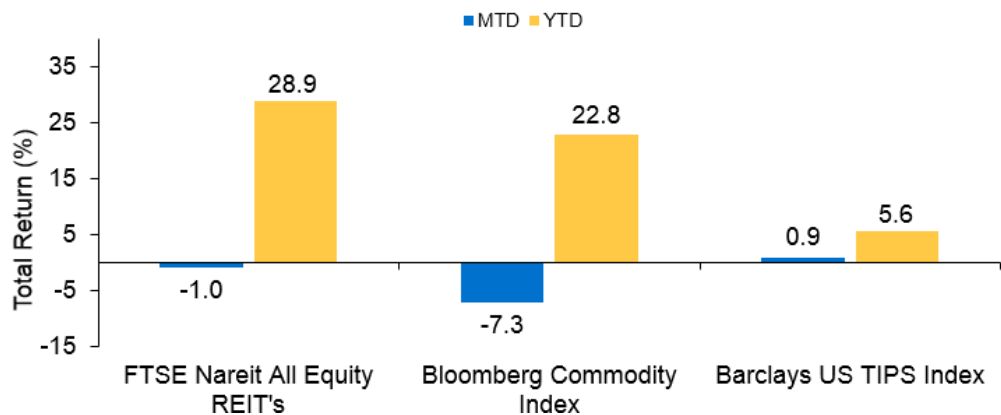
Global Fixed Income Returns
November 2021 - YTD



Alternatives

Alternatives have posted mostly strong returns for the year though gave some back in the month – particularly as energy prices fell on concerns of weakened travel demand due to the COVID variant. For

Alternative Market Returns
November 2021

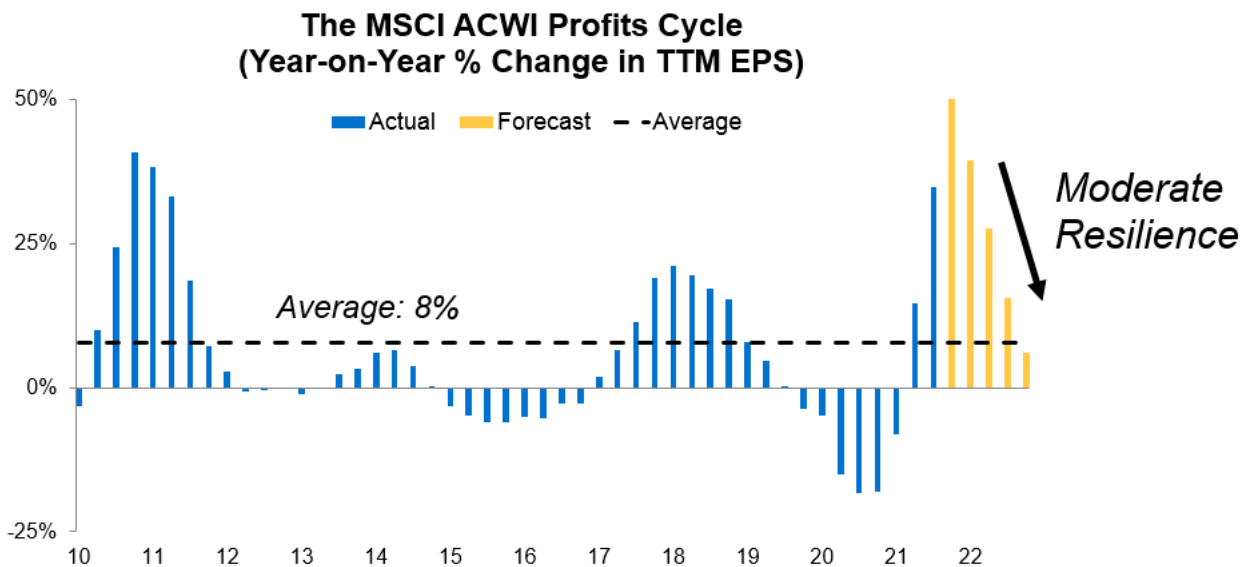


the year, however, commodity returns have benefited from rising Energy, Industrial Metals and Agriculture prices. Meanwhile, REIT's have held up better as they've been viewed as an attractive reopening opportunity though with some defensive yield characteristics.

Market Outlook

“It’s tough to make predictions, especially about the future.” – Yogi Berra (1925-2015)

As we turn the page to next year, we think the phrase “Moderate Resilience” might best define the environment. Said another way, moderating growth from an elevated level might apply to everything from corporate earnings to nominal GDP to inflation. Embedded within that view is the idea that the cycle is maturing, but money supply still growing at well above average suggests nominal growth might remain resiliently above average into next year. As can be seen in the chart below, global corporate profit growth is set to moderate next year – though, on a trailing twelve month basis, earnings growth won’t fall back in line with the longer term average until the final quarter of the year.



While that’s our base case, the Omicron variant is a risk factor that could accelerate the moderation process faster than anticipated. We think that happens IF this strain proves to be more transmissible, more virulent and more vaccine resistant and IF lockdowns come back into vogue, which would ultimately have the effect of slowing demand more dramatically.

At the same time, a key debate for next year continues to revolve around inflation. Markets are trying to figure out how quickly and to what level inflation will normalize and how the Fed will respond. To say that the Fed is in a tricky situation is an understatement.

The FOMC has been reluctant to remove accommodative policy given that the economy is still short about 4 million jobs relative to pre-COVID. Since 1960, it's taken an average of about 33 months to fully recover the jobs lost during the eight prior economic downturns. Currently, we're in month 22 which means we would need to see a little more than 350K job gains per month over the next 11 months to hit the goal. For context, we've been adding a little more than 600K jobs per month, on average, over the last 6 months. In short, the labor market is healing but has more work to do in order to get back to where it was pre-COVID.

At the same time, inflation has jumped to its highest levels in decades. Wage inflation is more than two standard deviations above the average since the early 1980's, suggesting the labor market is tighter than it appears. As noted in the table below, the last time the Fed started hiking rates was in December 2015. Back then, not only was the unemployment rate higher but inflation was much lower and yet the Fed felt comfortable raising rates. Ultimately, policymakers would hike rates nine times up until December 2018.

The Fed is in a difficult spot today because it must end its bond purchasing program (tapering) prior to hiking rates. Tapering was initiated in November by reducing bond purchases by \$15b per month. At that pace it would take eight months to remove the total \$120b of bond purchases that are occurring each month. Current indications suggest that the Fed is likely to accelerate the tapering of bond purchases so that it can address inflation with rate hikes thereafter. But with long-term rates lower and the curve flatter than last time, there's presumably less room to hike interest rates (before financial conditions get excessively tight) despite the presence of higher inflation.

	Fed Funds Rate	10 Year Treasury Yield	10 Yr -2 Yr Yield Curve	Unemployment Rate	CPI % 1 Yr	Wage Inflation % 1 Yr
Today	0.25%	1.43%	0.91%	4.2%	6.2%	5.9%
12/15/15	0.25%	2.27%	1.30%	5.1%	0.4%	2.1%

Source: Factset; December 15, 2015 denotes the beginning of the last Fed rate tightening cycle, which included 9 hikes ending December 2018.

In fairness (and as we've written about previously), we think inflation is likely to moderate from today's elevated levels as supply disruptions and COVID restrictions eventually ease (notwithstanding a bad scenario with Omicron) though we still think structural factors suggest that it remains above pre-pandemic levels. **In short, Moderate Resilience might be a good way to frame up the inflation backdrop as well.**

If markets can get comfortable that Omicron doesn't lead to more lockdowns and nominal growth remains elevated next year, this could have the effect of pushing long-term rates higher and give the Fed more cushion to combat inflationary pressures. If long-term rates stay relatively low, aggressive Fed rate hikes to combat inflation could be difficult for risk assets to digest. The interplay between how fast things Moderate and/or stay Resilient will be important in determining how the situation evolves.

From a portfolio positioning perspective, we think it will be important to strike the right balance between Moderation and Resilience. To us, that means managing the overall exposure and mix of risk assets (i.e. Moderation) while also being cognizant of the continued need for pro-inflationary tilts (i.e. Resilience). Candidly, this has been something we've been proactively doing in client portfolios for the majority of this year.

Currently, we are modestly OW risk assets after having trimmed this OW several times this year (via Equities and Alternatives) – including early in September – while having maintained diversification with lower volatility securities (via US Core Fixed Income and Diversified Alternatives).

Within equities, our positioning has moved closer to neutral but continues to favor a pro-inflation bias with a modest OW in US Small Caps and a more value sector tilt within our US Large Cap exposure (albeit with a quality bias).

Within fixed income, to mitigate some portfolio risk, we remain UW the most cyclical parts of the bond market (High Yield and Emerging Market Debt) but our US Core managers are OW credit and UW (defensive) treasuries. We also continue to carry a shorter duration bias (less interest rate sensitivity). Our US Core Fixed Income exposure remains an OW supplemented by our UW position in International Fixed Income which remains a hedge against a weaker dollar environment.

Within alternatives, we've more recently taken profits by trimming some of our exposure to real assets but remain overweight as a way to bolster inflationary hedges – thus we're OW to Real Estate and Commodities. Meanwhile, we are also OW to Diversified Alternatives which provide some hedge against market volatility.

The information presented in the material is general in nature, should not be considered investment advice, and is not designed to address your investment objectives, financial situation or particular needs. Information contained herein has been obtained from sources deemed reliable, but we do not guarantee its accuracy or completeness. The opinions expressed herein may not actually come to pass, are as of the date of publication and are subject to change at any time based on market, economic or other conditions.

You cannot directly invest in an index. Indexes are unmanaged and measure the changes in market conditions based on the average performance of the securities that make up the index. Performance results reflected do not include fees or other charges which impact an individual investor's returns. Investing in small and mid-cap stocks generally involves greater risks, and therefore, may not be appropriate for every investor. Alternative investments involve specific risks that may be greater than those associated with traditional investments. Asset allocation and diversification does not ensure a profit or protect against a loss.

First Financial Wealth Management, a division of First Financial Bank, provides investment advisory, wealth management and fiduciary services. First Financial Wealth Management does not provide legal, tax or accounting advice. The products and services made available by First Financial Wealth Management:

Are not deposits	Are Not FDIC Insured	Have No Bank or Federal Government Guarantee	May Lose Value
------------------	----------------------	--	----------------