APTUS CAPITAL ADVISORS

It' s Time to Curb Your Enthusiasm In 2022:

Source: The Guardian, 1/30/2020

At Aptus, we tend to release our annual market forecasting paper before the new year, because, if we were to release it afterwards, by the time we get it approved by compliance, it would be too late to wish anyone a *Happy New Year*. Given the politically correct landscape, this world is increasingly in need of a social martyr of sorts. A person so distraught by brazen contempt for social customs that they dive head-first into the business of others just to make a point.

That person is Larry David – he is someone who speaks his mind at inopportune moments, violating subtle boundaries, and then having to deliver forced apologies.

And, in the case of this forecasting paper, we are going to channel Larry's inner rich, old, and out-of-touch white guy persona, as he questions a few items, that may go against the politically correct answer that many advisors tend to adhere to.

Larry David: "So, the analyst's make the estimates, but they can't keep the estimates?"

Aptus: Yes; the consensus view rarely plays out in its entirety. Just take a look at the consensus levels that were broadcasted by economists heading into this year.

Analyst's Forecasts for 2021		
High	4400	18.89%
Low	3800	2.67%
Average	4064	9.80%
S&P 500 Actual	4613	26.47%

Source: Bloomberg,CNBC, Data as of 12/14/2021

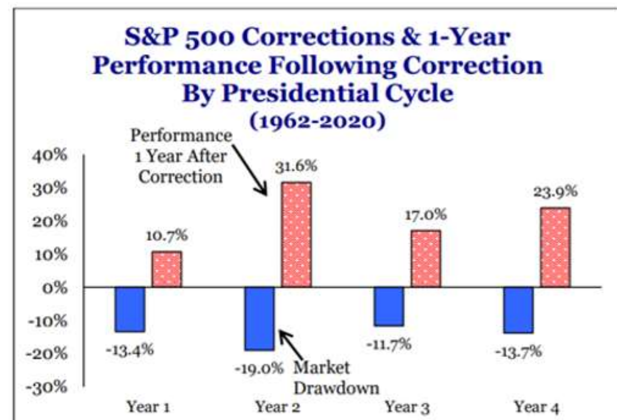
Analyst's Forecasts for 2022		
High	5300	14.89%
Low	4400	-4.62%
Average	4843	4.99%

Source: Bloomberg,Estimates as of 12/12/2021

Even the highest of expectations undershot the market return, as of 12/14/2021, by over 7.5%! Thus, we aren't going to give our forecasts in this paper – we believe that can be a waste of time prognosticating what equity markets will be returning next year. Instead, we're going to focus on the issues that have the highest probability of affecting clients next year.

Larry David: "Mid-term Elections occur in 2022 - people say I look like Bernie Sanders. I don't see it. Does this mean that the market may feel the burn as political uncertainty grows?"

Aptus: Next year is a midterm election year, which is the most volatile year for the S&P 500 in the four-year presidential cycle. In fact, the S&P 500 has averaged a 19% correction in a midterm election year with the other years averaging about a 13% drawdown. The good news is that these corrections have historically turned out to be great buying opportunities, with stocks up one year from the low every time since 1962, by an average of 31.6%. Taking this one step further, the S&P 500 has not declined in the 12 months following a midterm election since 1946. We believe this happens because the market anticipates that elected officials will push for a stronger economy ahead of the presidential election by loosening fiscal and monetary policy post-midterm election.



Source: Strategas, Data as of 12/10/2021

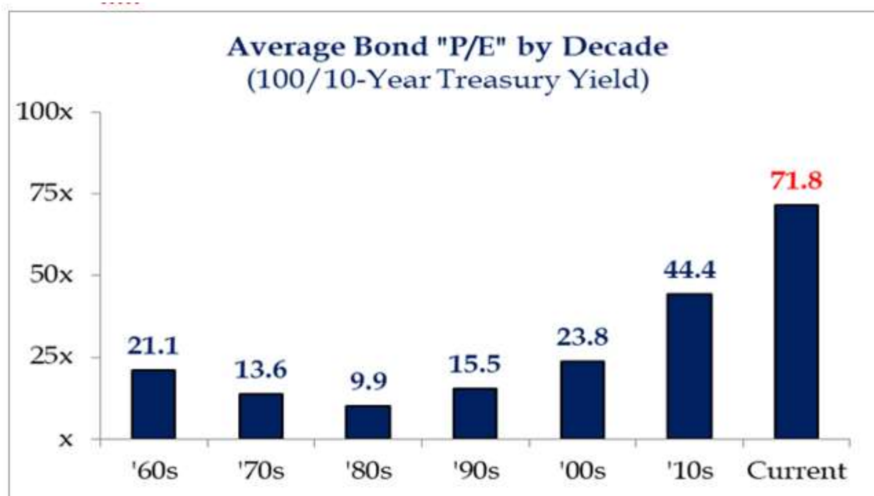
Larry David: “Anyone can be confident with a full head of hair. But a confident bald man – there’s your diamond in the rough. Being a confident bald man in retirement, I obviously have to own traditional bonds, correct?

Aptus: It’s no secret that we believe the prospect for traditional bonds is bleak. Given the current environment, we believe that traditional fixed income will not provide the same diversification and return benefits that they have historically provided. We have become increasingly bearish on longer-duration bonds due to the current interest rate environment, lack of growth, increased duration, and credit risk.

Interest Rate Risk – Moving forward, we believe the interest from fixed income securities continues to be minimal. There is no better predictor of bond returns than treasury yields – just look at the chart to the right. With yields on the lower end of the spectrum, the cushion (or re-investable dollars) available to offset the price effect from rising rates continues to decrease. We believe this will continue to be a major headwind to bond investments. Not to mention, if the Fed tapering playbook of 2013 taught us anything, it’s that when the Fed starts to tighten, rates tend to increase, a bad combination for fixed income returns.

Source: Raymond James, Data as of 11/30/2021

No Growth - Historically, valuations have been a great predictor of future returns. And right now, fixed income trades at 71.8x earnings – and that is before considering that these earnings cannot grow, cannot protect against the real effects of inflation, nor give you enough reinvestable income to offset the loss of purchasing power. If we compare that to the S&P 500, which trades at 21.0x earnings, bonds look even more expensive. Not to mention, stocks have the ability to grow. Simply put, it is reasonable for an investor to pay a premium valuation for a growing asset, not one that doesn’t have the ability to.



Source: Strategas, Data as of 12/1/2021

Increased Duration – The word duration is a daunting investment term that may sound like a foreign language to many. It simply refers to the sensitivity of an asset's value to changing interest rates - the higher the duration of an asset, the more sensitive it is to a change in interest rates. For example, higher duration means that the price of a bond will decrease by a larger amount relative to a bond with a lower duration, given the exact same change in rates. In today's environment, bonds have never had longer duration exposure, thus, they are substantially less insulated (from a pricing perspective) from an increase in rates than ever before.

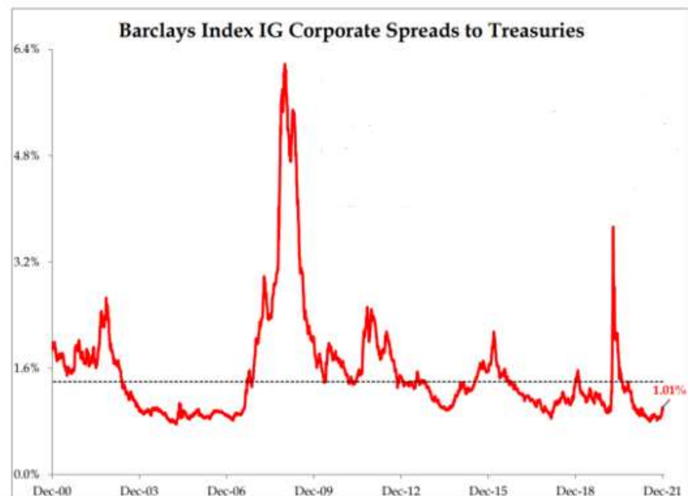
It's time to think about duration risk

Bbg Barclays, U.S. IG, HY, yield, duration, by credit rating, Dec 2019 vs. current

		December 2019			Current		
		Yield	Duration	Yield/Duration	Yield	Duration	Yield/Duration
Investment Grade	AA	2.4	7.4	0.32	2.0	10.1	0.20
	A	2.6	7.9	0.33	2.0	8.4	0.24
	BBB	3.1	7.9	0.39	2.4	8.6	0.28
High Yield	BB	3.6	3.4	1.06	3.3	4.7	0.70
	B	5.1	2.7	1.89	4.7	3.3	1.42
	CCC	10.4	2.9	3.59	6.6	3.0	2.20
	CC/D	21.0	3.3	6.36	21.8	3.9	5.59

Source: Pavillion, Data as of 11/29/2021

Increased Credit Risk – Credit spreads have been in a tight range since February. Supporting the view that spreads could stay around current levels, or even dip lower is the astonishingly low, i.e., the trailing twelve-month default rate is about 0.50%. To say that this rate of default is low is an understatement, as we've never seen a level this small before. Furthermore, lower credit spreads inject potential equity risk into bond portfolios, as spreads could widen during a risk-off environment. As 2022 progresses, a more worrisome macro landscape is likely to come into view for 2023, and spreads should begin to widen ahead of what we believe is shaping up to be a mid-cycle slowdown in 2023, potentially hurting bond prices.



Source: Strategas, Data as of 12/8/2021

Larry David: "Tuesday has no feel. Monday has a feel, Friday has a feel, Sunday has a feel. What's your feel on the market next year?"

Aptus: As mentioned before, we don't want to prognosticate a return to the market for next year – though we would say that we expect annual returns to begin to normalize. The outsized return that investors have received from stocks over the past ten years falls within the 1st percentile of rolling 10-year periods dating back to 1963. Simply put, the past ten years have rewarded households with arguably what could be the best stock return spreads of their lifetime. Even more recently, the cumulative return, as measured by the S&P 500, has been around +88% over the last three years.

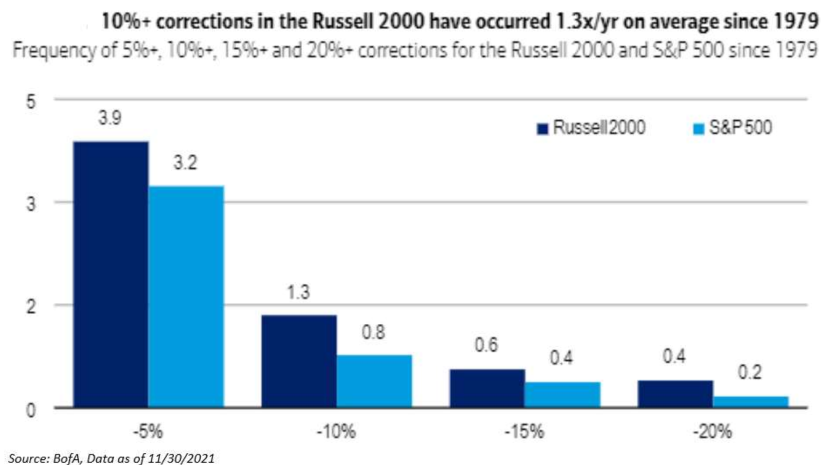
Moving forward, given a slew of various reasons (to be discussed below), we believe that investors need to ***Curb Their Enthusiasm*** heading into 2022.

The Great Normalization

The U.S. market has reached an astounding 67 record highs this year and it seems as if most people, at least in the United States, have come to some uneasy truce with life in the COVID era. Although inconveniences are still present, life is more or less vectoring back towards *normal*.

Although it has been frustratingly slow, the economy does appear to be *normalizing*. The world is *normalizing*, which is good news, but it will likely take a few years for a complete *normalization* process, and obviously inflation will be elevated as demand comes back faster than the economy's ability to supply in the near term. More importantly, there's a lot of reasons to be pessimistic right now. We have some concerns for next year – a market in transition, midterm election year, inflation, an anxious Fed, etc. – but "the market is up a lot" or "we're due" shouldn't be one of these worries.

Based on the shape of the yield curve, the drop in unemployment claims, and a vast reservoir of personal savings (~ $2 trillion), we believe the odds of a recession in the U.S. are low in 2022, but that doesn't mean that next year will be a smooth ride. Historically, we know that the market tends to see one 10% pull back and three 5% pullbacks on average in a year.



We'll be the first to admit that the environment that persisted in 2021 could persist in 2022. For all the talk of a "resilient market", under the surface, the churn in terms of drawdowns was significant over the past year – currently, the average stock is down 13%, but the market is just coming off all-time highs. Rotational corrections are preferred over the bottom falling out all at once but there is a risk that indices, at some point, reflect more of the weakness that has persisted under the surface over the past year.

The economic and political environment has been permanently altered from its pre-COVID days, although the changes are not necessarily due to the pandemic itself. What this really means from an investment standpoint is higher nominal GDP led by higher inflation, which is the only solution to our over-indebtedness. Ultimately, this should lead to greater investment and higher productivity, but that will likely take years. In the meantime, we will have to deal with the excesses and uncertainty created by the extreme nature of this recession and recovery. That breeds higher dispersion, making stock picking next year more important than ever.

This means that investors need to continue to remain balanced - don't get too bearish or too bullish. Don't get too growthy or too deep value. Don't get too defensive or too cyclical. Own high-quality stocks. This style tends to outperform during periods of slowing growth and economic uncertainty.

Moving into next year, fundamentally speaking, we are closely watching two aspects of the market:

1. *Valuations*: Currently, the S&P 500 is trading at 21.0x forward earnings, placing it in the 90th percentile, relative to history, i.e., stocks appear expensive.
2. *Earnings Growth*: Coming out of a recession, the market tends to have substantial earnings growth. But we believe that we are at peak earnings growth, moving to a more normalized type of environment.

If you follow anything that we do, we look at asset classes and stocks the same way – through our *Yield + Growth +/- Valuation Framework*.

	Yield	+	Growth	+/-	Valuation Change	=	Total Return
Avg. Annual Contribution to Return	3.20%		4.90%		1.10%		9.20%

Source: Bloomberg, Data as of 11/31/2021

Historically speaking, over longer periods of time, the change in valuation has not been a sustainable market driver – the market tends to be driven by yield and earnings growth. Next year, we believe that valuation multiples will continue to compress. Like we saw in 2021, the market will have to see faster earnings growth than multiple contraction to obtain some sort of positive market return - earnings expectations are already high and P/Es are set to decline.

Source: Goldman Sachs, Data as of 11/30/2021

While bottom-up consensus estimates for 2022 imply a 9% gain in earnings next year, that is likely to get cut by however much P/Es decline. If P/Es decline 1 point, that 9% falls 4%. A drop of 2 points gives you a FLAT market. We believe that P/E compression is more likely in the second half of 2022 as an improvement in the COVID backdrop, inflation pressures and perceived Fed hawkishness is likely help minimize P/E compression in the first few months in 2022.

"The U.S. consumer is feeling pretty good. Pretty, Pretty, Pretty, Pretty Good" – Larry David

The *biggest* key to success in 2022 is the consumer itself – almost 70% of the U.S. GDP is derived from consumer spending. And right now, the average American has never been in better shape. U.S. household net worth hit a

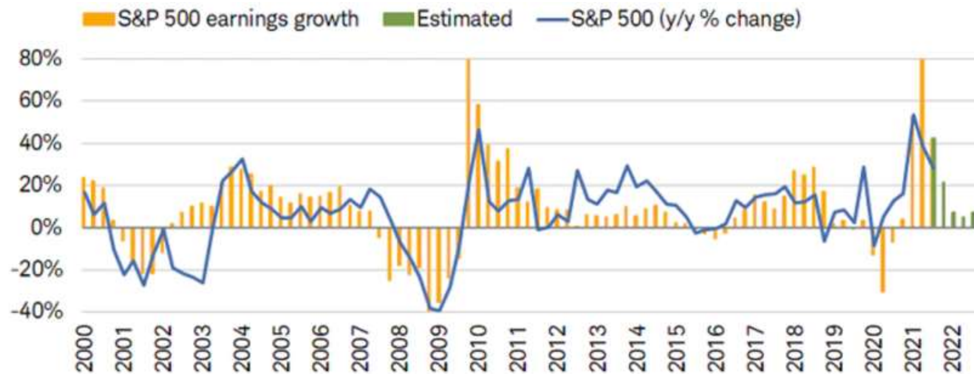
record $141.6 trillion last quarter. However, setting a new record is not unique; since clawing out of the Great Financial Crisis hole, net worth has been on an upward trajectory, setting all-time highs in 31 of the last 34 quarters. Rather, it is the sudden verticality in the change of net worth that is notable. At 28.1% growth over the five quarters, net worth is growing at its fastest pace of the post-war era.

U.S. Household Net Worth ($T)

	Q2 2021	Q1 2020	COVID 5 QTR. % Change	Q2 2011	10-YR Change (%)
Total Assets	$ 159.3	$ 127.1	25.3%	$ 81.6	95.2%
Deposits	$ 17.1	$ 13.9	23.0%	$ 8.6	98.8%
Total Stock Inv.	$ 47.0	$ 26.5	77.4%	$ 15.7	199.4%
Other Fin'l Assets	$ 49.2	$ 46.1	6.7%	$ 31.9	54.2%
Real Estate	$ 34.9	$ 30.6	14.1%	$ 18.4	89.7%
Other Non-Fin'l Assets	$ 11.6	$ 10.0	16.0%	$ 6.9	68.1%
Less: Total Liabilities	$ 17.7	$ 16.6	6.6%	$ 14.1	25.5%
Total Net Worth	$ 141.6	$ 110.5	28.1%	$ 67.5	109.8%

Source: Federal Reserve, Aptus Capital. Data as of 9/30/2021.

We believe the key to domestic market returns in 2022 will be driven by how much of this excess capital will be spent. This data will be the focal point of earnings growth next year. S&P 500 earnings have been on fire since mid-2020; with a sharp v-recovery. Earnings growth, although still strong in an absolute sense, is expected to descend through at least the first half of next year. As mentioned before, next year, Wall Street analysts are expecting earnings growth close to 9%.



Source: Charles Schwab, Data as of 12/13/2021

As shown above, there is a close historical relationship between the growth rate in S&P 500 earnings and the year-over-year change in the index itself. This in and of itself isn't a warning of impending doom; but is perhaps a message to curb your enthusiasm about future equity market returns remaining as robust as the pace of the past 20 months – the S&P 500 has doubled since the COVID-bottom.

Readers are keenly aware of concerns we have about the investing landscape in 2022. But what should not (never) be inferred is that we suggest investors should be "getting out." One of my oft-expressed mantras about investing is that neither "get in" nor "get out" is an investing strategy—**that simply represents gambling on moments in time, while investing should always be a disciplined process over time.**

That discipline should involve diversification—across and within asset classes—and periodic rebalancing. Investors need to remain extremely alert to the risks of monetary policy, inflation, speculative froth, and ongoing virus concerns. But what ultimately matters is not what we know about the future; it's what we do along the way.

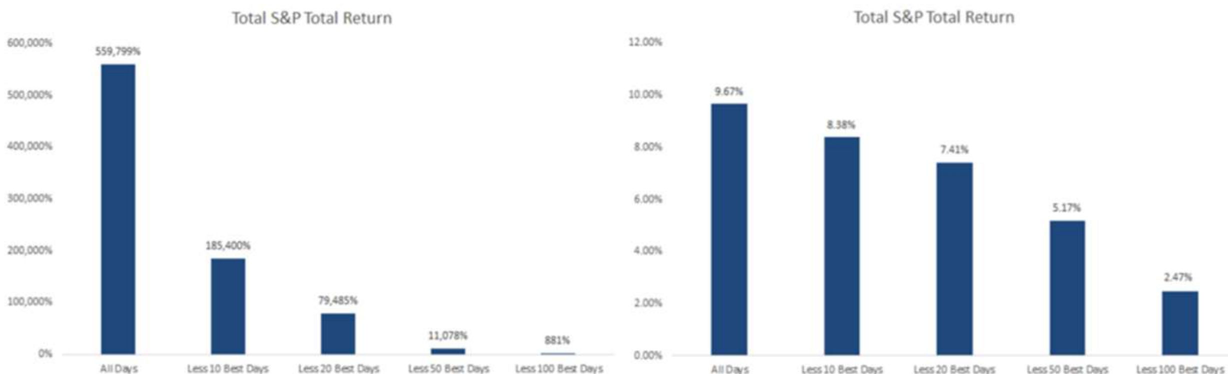
"I'd rather have the thieves than the neighbors – the thieves don't impose. Thieves just want your things, neighbors want your time. I'd rather give them things than time." – Larry David

Time is a very important concept in both life and investing. An investor's time in the market and the power of compounding has been coined Einstein's 8th wonder of the world - but many people often lose sight of the former – time in life. So, we'll leave you with our takeaways on both.

1. *Time in the Market*: The market continues to trade around all-time highs. Our recency bias has accustomed us to seeing markets at these all-time highs, but that is atypical as stocks historically are at all-time highs only 30% of the time. The other 70% of the time, investors are trying to recapture previous highs - 20% of the time, markets are in a bear market drawdown of 20% or greater, which is likely a far higher percentage of the time than many investors realize.

   Although it's easier said than done, ignoring the day-to-day gyrations in the market and headlines for rationalizations of sell-offs is often the best strategy. We would all love to time the market to miss the worst days and only be invested on the best days, but that is impossible. **Most importantly, the only way to reclaim lost returns is to stay in the market.**

   As the charts below shows, missing just the ten best days over the last 93 years would result in annualized returns of 1.4% less than being fully invested.



Source: Bloomberg, Aptus Capital, Data as of 1/1/1928 – 9/30/2021

2. *Time in Life*: The other month, we first heard the phrase – "*Time Billionaire*". What is a *Time Billionaire*?
   Average Lifespan of an American: 79.0 Year / *The Length of 1 Billion Seconds*: 31.7 Years
   If you're 47 or younger, that means you're a time billionaire. You likely have 1 billion+ seconds left in your life. If you're 20, there's a decent chance you're a multi-time billionaire. Our society places more value on being a dollar billionaire. We believe that people severely overvalue the dollar billionaire and undervalue the time billionaire. In our opinion, this is flawed.

   Time is the most precious asset in the world. Everybody has the same amount of time each day. You can't buy more of it. It's the only thing in our lives that we can't reacquire once it's gone. On average, we spend: 26 years sleeping, 7 years trying to fall asleep, 13 years working, 8 years watching TV, 5 years eating, 3 years on social media, and 3 years commuting (plus a few random years on miscellaneous).

   This leaves us with 6.8 years of free time – *how will you spend yours*?

At Aptus, we are privileged to work with every one of you. We are blessed for all of our new relationships, and for those relationships that we've had for a long time – we would not be who we are without each and every one of you. Everyone reading this outlook is the life blood of our company, and we couldn't be more proud of everyone being a part of our lives. We wish everyone a safe and healthy new year.

Happy Livin',
The Aptus TEAM.

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The Bloomberg Barclays U.S. Corporate High-Yield Index covers the U.S. dollar-denominated, non-investment grade, fixed-rate, taxable corporate bond market. Securities are classified as high-yield if the middle rating of Moody's, Fitch, and S&P is Ba1/BB+/BB+ or below.

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