CCT
ASSET MANAGEMENT

# Investment Update — January 2022

*This is a quarterly update of economic conditions and investment strategy.*

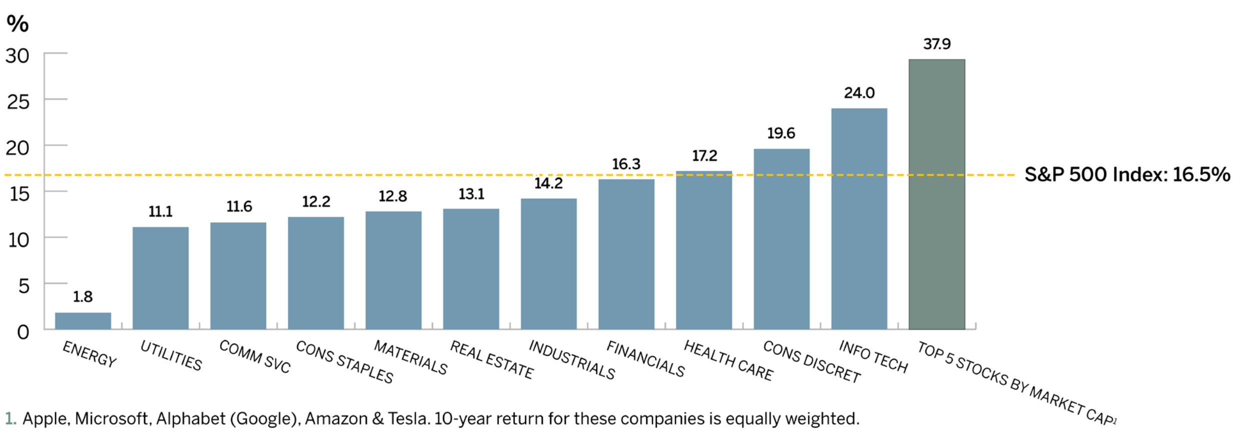
## U.S. Equities Shrug Off Insurrection, Infections and Inflation

2021 was a difficult year. It started with an *insurrection*, witnessed record COVID-19 *infections* and ended with the highest *inflation* in almost 40 years. But U.S. equity markets largely shrugged off these events. The S&P 500 generated a total return of 28.7% in 2021, a remarkably strong result after its 18.4% return in 2020. The S&P 500 also outperformed major non-U.S. benchmarks, including the MSCI EAFE and MSCI EM indices, which delivered total returns of 11.9% and -2.5%, respectively. Much of the S&P 500's outperformance in 2021 was due to the rapid reopening of the U.S. economy and resurgent consumer spending, driven by vaccine rollouts and the impact of Pandemic-driven fiscal and monetary stimulus.

## A Long Bull Run

Impressive as S&P 500 returns have been for the past two years, its longer-term performance is more noteworthy. Over the past 10 years, the S&P 500 has returned 362%, or an average of 16.5% per annum. The outsized performance of S&P technology stocks – and a small subset of high growth leaders – propelled the Index higher.

### Ten Year Annualized Return for S&P 500 Sectors and Five Largest Stocks by Market Cap




1. Apple, Microsoft, Alphabet (Google), Amazon & Tesla. 10-year return for these companies is equally weighted.

Source: Trahan Macro Research

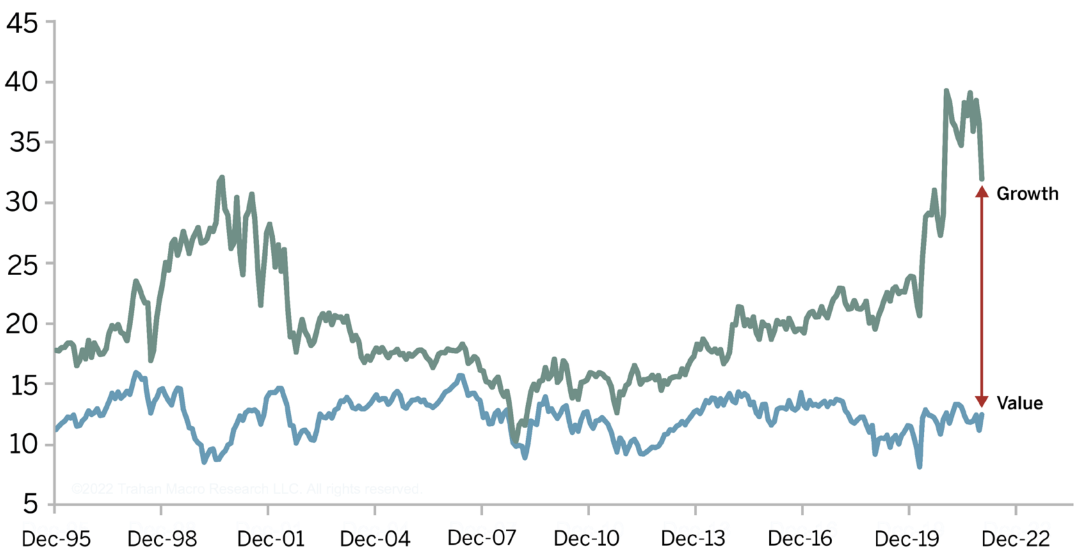
After outperforming in each of the last eight years – including 2020, when it beat the S&P 500 by a stunning 29 percentage points – the technology sector, broadly defined, now accounts for roughly 40% of the S&P 500. The five largest stocks by market capitalization – Apple, Microsoft, Alphabet (Google), Amazon and Tesla – now account for a greater share of the Index than at any time since the 1960s. For most of the S&P 500's history, the largest companies have come from a mix of sectors and industries. We've never seen anything close to this level of concentration, even during the Dot-Com Bubble.

After this record run, U.S. technology related stocks are expensive, trading at an average of 27 times forward earnings at year end. This level is higher than at any point in 20 years on an absolute and relative basis. About 34% of tech-related stocks are trading at more than 10 times revenue. About 32% are unprofitable.

The outperformance of broader tech has also contributed to Growth stocks' sustained outperformance versus Value stocks. The valuation gap between Growth and Value stocks has reached an all-time high.

### Record Valuation Gap Between Growth and Value

Forward Price-to-Earnings Ratio of S&P Pure Growth and Pure Value




Source: Trahan Macro Research

For much of the past decade, market action has been dominated by one trade: buy the big tech leaders and ignore everything else. That strategy paid off handsomely for years, particularly for active managers focused solely on Growth, and for passive investors with a large exposure to these stocks through their ownership of the Index.

But all good things must come to an end. Although extreme imbalances can last longer than expected, they cannot be sustained indefinitely. Ultimately, we expect the tech sector and the big winners of the past decade to lose leadership. This may occur suddenly (as when the Dot-Com Bubble burst in 2000 or when the Nifty Fifty broke in 1974) or slowly, by lagging other sectors' returns.

## Structural Changes Afoot

We expect macroeconomic changes that are underway to drive the rotation away from tech and alter the market leadership that dominated the 2010s.

The U.S. economic rebound from the COVID-related recession has been truly remarkable.

- Adjusted for inflation, U.S. real GDP grew at an estimated 5.6% in 2021, faster than in any year since 1984.
- The unemployment rate dropped from 14.8% to 4.2% in just 19 months. After the Great Financial Crisis, it took almost a decade for the unemployment rate to achieve a similar decline.
- U.S. corporate earnings as a percent of GDP are now at an all-time high.

Although we expect economic growth to moderate in 2022 from these record levels as fiscal support fades and the Fed begins to raise interest rates, we think it will remain well above the very low levels of the last decade. Growth in consumer spending should remain healthy even as stimulus declines. After the deprivations of the pandemic, consumers are eager to spend and well-positioned to do so. U.S. household debt service as a percent of income is near all-time lows due to a decade of deleveraging, wealth created from rising asset prices, and savings accumulated during the pandemic.

This growth in consumer demand has occurred alongside a broad set of supply constraints, leading to the recent rapid rise in inflation. The Consumer Price Index rose to 6.9% in November, its highest level since 1982.



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We have been focused on inflation for some time. In our second-quarter Investment Update, we shared our proprietary framework for assessing both short-term and long-term inflation pressures. We have continued to update our views over the past six months as inflation pressures intensified and the topic became central to the market debate.

Our framework led us to predict surging near-term inflation. And while many investors believe inflation will be transitory, our framework leads us to predict that inflation will moderate but stay higher than at any time since the 1980s.

### Chevy Chase Trust Inflation Framework
Drivers of Inflation over Different Time Frames

| Short-Term Drivers | 2011 | Q2-21 | 1H-22 |
|---|---|---|---|
| Consumer Wealth/Leverage | -5 | 5 | 5 |
| Fiscal Stimulus | -3 | 5 | 0 |
| Central Bank Policy | 1 | 5 | 2 |
| Cyclical Demand | 2 | 5 | 3 |
| Commodity Supply/Demand | 3 | 5 | 4 |
| **TOTAL** | **-2** | **25** | **14** |
| Consumer Price Inflation (CPI)[1] | 3.1% | 6.9% | *4.5%* |

1. CPI data are average for 2011, November 2021 and CCT forecast for 2022.

| Long-Term Drivers | 2011 | 2021 |
|---|---|---|
| Globalization of Labor and Supply Chains | -5 | 2 |
| Shift from Fossil Fuels | -2 | 5 |
| Consumer Balance Sheet | -3 | 2 |
| Technology/Moore's Law | -2 | 2 |
| Demographic Trends | -3 | 0 |
| Productivity Gains | -2 | -2 |
| Government Debt Levels | -1 | -4 |
| **TOTAL** | **-18** | **5** |
| CPI over the following decade[2] | 1.7% | *3.0%* |

2. 2011-2020 average annual CPI and CCT *forecast for 2021-2031 average annual CPI.*

## Why Inflation Matters

Over the past 50 years, the most important economic development for investors to get right was inflation: its sharp rise in the 1970s and its later, multi-decade decline. The importance of inflation to financial markets cannot be overstated. It impacts interest rates, equity market multiples and relative asset class performance.

Well-respected economists and investors have predicted the return of high inflation at several points over the past 40 years. Perhaps the most vociferous calls for inflation came after the Global Financial Crisis, (GFC). Pundits pointed to the massive liquidity that the Fed had pumped into the U.S. economy and argued that rock-bottom interest rates, swollen central bank balance sheets and high government debt loads were a recipe for inflation. Yet inflation remained extremely low for the subsequent decade.

Ten years later, in the wake of another massive crisis, global interest rates are again at rock-bottom levels, central bank balance sheets are even more bloated, and government leverage remains high. But this time, expectations for future inflation are remarkably tame. Nonetheless, we think inflation will rise this time, at least to levels higher than the prior decade, because the global economy has changed in important ways since 2011.

In 2011, U.S. consumer leverage was very high, and consumers were just beginning to pay down the excessive debt that contributed to the GFC. For most of the following decade, debt reduction slowed consumer spending and economic growth, and put downward pressure on inflation. Today, by contrast, debt servicing eats up a smaller share of consumer income than at any point in half a century, and re-leveraging could ignite a new consumer-spending boom.

In 2011, governments in Europe and the U.S. were returning to austerity in fiscal policy, which slowed economic growth and inflation for years. Policymakers learned from the tepid recovery. They have been spending far more liberally in response to the pandemic.

In 2011, China was still evolving as the World's Factory Floor. As companies around the world outsourced production to China, the country added an average of approximately 15 million low-wage workers to the global labor force for several consecutive years. This caused a significant shift in power from labor to capital, depressing wages globally. Today, however, China's labor force is declining by 5 million workers per year, and U.S. baby boomers are retiring en masse. As a result, power is shifting back from capital to labor, and wages have begun to rise.

In 2011, China was powering its factories with abundant local coal, in effect giving the companies that relied on Chinese manufacturing unfettered access to cheap energy without paying penalties for the environmental damage caused. But China's coal usage plateaued in 2015, and today China is focused on reducing its carbon footprint to mitigate climate change. China is unlikely to continue subsidizing the global economy by liberally burning coal.

Each of these changes is likely to have meaningful implications for investors. Taken together, they likely mean that the strong deflationary headwinds of the last decade are behind us.



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## Portfolio Positioning

We expect higher inflation and the pandemic recovery to continue to impact financial markets in the years to come. The exact timing and magnitude of these events are difficult to predict with confidence. Because of this timeless challenge, we have always focused our energies principally on understanding thematic secular drivers of company and market value. That is truer now than ever.

We're relying on our deep research in our six portfolio themes to find stocks with advantages that will support earnings growth and lead to outperformance in the years to come. Each of our themes (The End of Disinflationary Tailwinds, Heterogeneous Computing, Long-Term Crisis Beneficiaries, Next-Generation Automation, Molecular Medicine, and Increasing Wealth Concentration) appears to be gaining traction.

In sector terms, we have increased positions in value-oriented Energy and Materials firms, which generally benefit from inflation, and we've maintained an overweight in the historically defensive Healthcare sector. Although many of our healthcare holdings are more "Growth-y" than the average healthcare stock, we think several of these companies are well-positioned to emerge as new leaders in a rapidly changing healthcare landscape. We are willing to hold them even if large-cap Growth stocks, as a group, lose favor for a time.

We have reduced the portfolios' overweight of Growth stocks, particularly Technology stocks, over the past few quarters. While our portfolios have retained core positions in some of the big winners of the last decade, the portfolios are now underweight the big tech-related stocks mentioned earlier. Granted, many of these companies still have favorable characteristics, such as high revenue per employee, limited competition and ample growth opportunities. But their valuations fully reflect these advantages, and the prospect of higher inflation increases the odds of strong relative returns for other stocks.

Our portfolios have become more balanced across factors and less tilted to Growth than at any time in the past eight years. We think this both reduces risk and increases the odds that the portfolios will outperform as markets navigate a complex set of cross currents.

## Significant Portfolio Actions in the Fourth Quarter

### London Stock Exchange Group plc

In the fourth quarter of 2021, we exited our position in London Stock Exchange Group plc (LSE), a global financial markets infrastructure business. When we initially purchased the stock three years ago, LSE was in the process of closing an acquisition of Refinitiv, a leading financial data and analytics provider. We believed the acquisition would create a global footprint with diversified revenue and significant growth opportunities and would meaningfully increase LSE's recurring subscription-based revenue. Following the integration of Refinitiv, management announced higher than expected upfront investment spend and telegraphed a slower than anticipated pace of revenue synergy realization, both of which should result in a longer than expected time horizon to deliver margin improvement. Our decreasing confidence in the medium-term outlook caused us to exit the position.



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