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2001 Kirby Drive, Suite 1200
Houston, Texas 77019-6081
www.sentineltrust.com

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2021 Recap and 2022 Investment Outlook

Executive Summary

- 2021 was a year for the history books in more ways than one. From GameStop to Omicron, the year was full of surprises. Despite rising inflation, central bankers remained extremely easy and asset prices ran hot. US stocks gained 25%, oil jumped 50%, and bonds fell just -1.5%.
- 2022 will likely have its fair share of surprises and a lot will depend on how the Federal Reserve fights inflation and moves from an extremely easy stance to a more restrictive one.
- No one has a crystal ball in predicting what lies ahead. We see three basic scenarios that may play out and have tilted portfolios toward the more inflationary outcome. Given the level of uncertainty and our role as fiduciaries, we are not putting all our eggs in this one basket. We remain focused on diversification, liquidity, and flexibility as we expect more volatility ahead.

2021 Recap

Before diving into our forward outlook for 2022 and beyond, we should take a moment to reflect on 2021 and what a remarkable year it was. Perhaps the best way to illustrate the unusual events endured by the populace and the markets in 2021 is with a chronological list of the selected top Google trends. Some of the most Googled terms in 2021 were, in order: "siege on Capitol," "second impeachment," "blue wave," "taxes," "GameStop," "Texas freeze," "vaccine," "shooting," "hate crime," "Delta," "inflation," "cicadas," "wildfires," "earthquakes," "Afghanistan," "Omicron," and "tornado."

Despite all of these shocks and concerns, most assets delivered exceptional returns aided by several factors. Global central bankers remained very easy, perhaps too easy, flooding the world with ultra-low yielding cash. The threat of higher US taxes never materialized but generous fiscal stimulus largely continued. Humanity continued to learn how to deal with COVID. All of these factors led to exceptional earnings, some surprising inflation, and generally strong returns.

If we think of the global economy and assets in 2021 on a "Goldilocks" spectrum, things were probably a little too hot but few investors would complain. Bonds, as measured by the taxable, broad-based Bloomberg US Aggregate, fell just -1.5%, with most of the damage done by Q1. Despite the fact that this was one of the worst years for bonds in more than forty years, most bond investors likely gave a sigh of relief with inflation pushing from near 1% toward 7% in 2021. The lack of yield on cash and Treasuries coupled with the threat of higher taxes helped other bond categories like municipals and both taxable and tax-exempt high yield debt post positive nominal returns.

The too-hot nature of 2021 favored more inflation-sensitive assets likes stocks and commodities. The broad-based Russell 3000 jumped 25.6% with the bulk of these gains stemming from a handful of stocks. Active managers and hedge funds struggled on a relative basis with broad hedge fund indexes up just 8-10%. 2021 was a difficult environment for stock pickers with meme stocks jumping wildly, the market swinging from value to growth and back, and with many stocks experiencing significant declines despite index strength. The strong dollar, a more restrictive and autocratic Chinese government, and new COVID variants also crimped international returns on a relative basis. The MSCI World Ex-US Index ended up just 8.5% on the year. Real assets and commodities were by far the big winners in 2021. Inflation concerns and an improving global economy drove public real estate up 26% and oil up over 50%.

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2022 Outlook

Neither Sentinel Trust nor any firm or individual can predict with perfect accuracy how 2022 will turn out. If someone was informed of the shocks we would see in 2021 ex-post, it is doubtful they would predict the returns above ex-ante. The median Wall Street forecasted expected return for stocks from 2000-2020 missed the actual return by just under 13%, more than double the actual average return delivered by the market. As we head into 2022, these forecasts have rarely been wider and for legitimate reasons. We will focus the rest of our time here discussing what we see as the three most plausible scenarios ahead, why they may play out, what they may each mean for markets, and how we are thinking about and positioning portfolios.

Markets Overheating- Too Hot

As noted above, 2021 was, in many ways, an economy that ran a little too hot and the Fed was likely too easy. Jobs are plentiful and wages are rising but rents are up, basic items are expensive, and houses are scarce. Unemployment fell from 7% to 4% while inflation ran from 1.5% to 6.8% in 2021. In normal, non-pandemic circumstances, these factors would suggest the Fed is well behind the inflation curve: its balance sheet is expanding and interest rates are still near zero. Continued supply chain disruptions from China's zero COVID policy, tensions with Russia coupled with years of underinvestment into energy and de-globalization all potentially could be accelerants to inflation concerns. The first two weeks of 2022 have largely been a continuation of this too-hot theme.

We have been concerned about this too-hot scenario for some time and have made numerous adjustments. First, after allowing cash balances to run low for most of 2021, we focused more recently on rebuilding them. Whereas we were comfortable in mid-2020 and early 2021 investing cash in short-term funds, we have eliminated this exposure more recently. We also remain underweight most bonds and are keeping our interest rate risk below benchmark. We shifted our internal municipal bond portfolio from a "buy and hold" strategy to a "high turnover" strategy that can harvest losses in an inflationary environment.

We remain underweight emerging markets with the view that emerging economies and consumers suffer the most under high inflation. We have generally reduced our broad, passive US equity exposure recently and expect to continue to do so. Where we are active, we have generally leaned into the more cyclical sectors of the economy like energy and materials which can benefit from inflation. We have also tilted more toward value stocks, international stocks, and quality companies that we believe can pass on higher prices to their end customers. Finally, we increased our real estate and real asset exposure in 2021 with a focus on single- and multi-family housing, energy, gold, and farmland, which we view as good inflation hedges.

Goldilocks- Just Right

While we have tilted more of our portfolios toward this "too-hot" scenario, we also still see a good chance that the Federal Reserve can tighten policy in a way that is just about right for the markets. Jerome Powell, the rare Republican reappointed by Democrats, has pivoted from hawkish to dovish before in 2018. He made a similar pivot from dovish to more hawkish recently and appears to be data driven and apolitical. He may also be assisted on the inflationary front by continued gridlock in Washington, a pandemic turning to an endemic allowing more Americans to get back to work, and by China easing its recent restrictive policies post-Olympics. Inflation has also struggled against the long-term themes of demographics and debt.

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Under this scenario, most assets should do quite well. Bonds may not deliver much but they would avoid deep losses and certain areas like high-yield and emerging market debt may do quite well. The bull market in US equities could continue even if not at the 25% per annum rate we've experienced over the past three years. In many ways, this would be a good thing as earnings can catch up with prices and stocks can become more fairly valued. International markets again could fare quite well in this environment, buoyed by a lack of significant inflation, a potentially weaker US dollar, and a global recovery. Lack of significant inflation may also crimp the recent returns we have seen from real estate and real assets.

While this is the scenario we hope for most, we do not invest with hope. We think even if the Fed gets things just right, the "soft landing" will still be turbulent. We expect, even under this "best case" scenario, to see bouts of volatility, whip saws between growth and value, and moments of both fear and exuberance. We think we can navigate this potential turbulence ahead by raising cash toward and above our targets; remaining nimble, liquid, and highly selective on illiquid investments; and maintaining our long-term focus.

Markets Hard Landing- Too Cold

While we think this is the least likely scenario, we do think there is a possibility the Fed over tightens into what may be more transitory inflation. The inflation experienced recently could cool significantly for a host of reasons. A new, more severe COVID variant could further dampen animal spirits. China may continue to be more restrictive than most had imagined. A quick and deep correction to risk markets and housing prices could further diminish US consumers' willingness to spend. Geopolitical risk still also looms large with coordinated cyberattacks on the rise. Any of these events, or some unknown event on no one's radar, could shock the global economy toward recession. Under this scenario, bonds, especially US-focused bonds, may do quite well despite their ultra-low current yields. Equities would likely struggle broadly and commodities may be the last place investors would want to turn.

Again, this is not our base case but as fiduciaries we have a responsibility to protect portfolios as best we can against foreseeable risks. This is why we still own bonds and cash despite their low yields, why we own hedge funds that can be both long and short the market, and why we place a special focus on looking for companies that are anti-fragile. These are firms with unique business strengths that enable them to shine not only during good times but also during chaos and disorder.

Summary

In sum, 2021 was a remarkable year. We are thankful for the returns most assets delivered. As we look into 2022, we see a significant amount of uncertainty. We have made numerous adjustments to portfolios to prepare for what we expect to be a more volatile and difficult road ahead. We believe our long-term focus, diversification, liquidity, and anti-fragile assets will help guide us through 2022 and beyond.

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