ALASKA PERMANENT
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APCM’s 2022 Market Outlook:
Mid-Cycle Investing Requires Selectivity

In my last blog, I highlighted 5 Key Takeaways from our 2022 Outlook which summarized our preference for equities and alternative assets over fixed income in light of our expectations for higher interest rates. In today’s blog, I’ll elaborate on a couple of areas within the equity markets we find most attractive. In my final blog of this series, I’ll explain how we are controlling risk given our expectation for higher market volatility in 2022 and struggling fixed income returns.

Commodities with a Twist

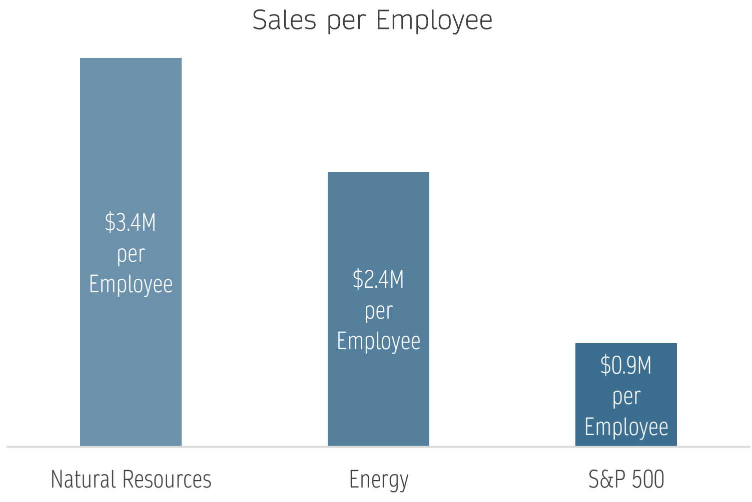
There are several million people who were participating in the labor markets before the pandemic that are not currently seeking employment. We expect half of those people retired early and will never re-enter the labor force, and the other half to only gradually re-enter, so it will take some time for wage pressures to begin to ease. When the demand for labor is stronger than supply, wage pressures begin to build. Wages are usually the largest expense for companies so increasing wages will exert downward pressure on profit margins, but thankfully margins are elevated relative to history.

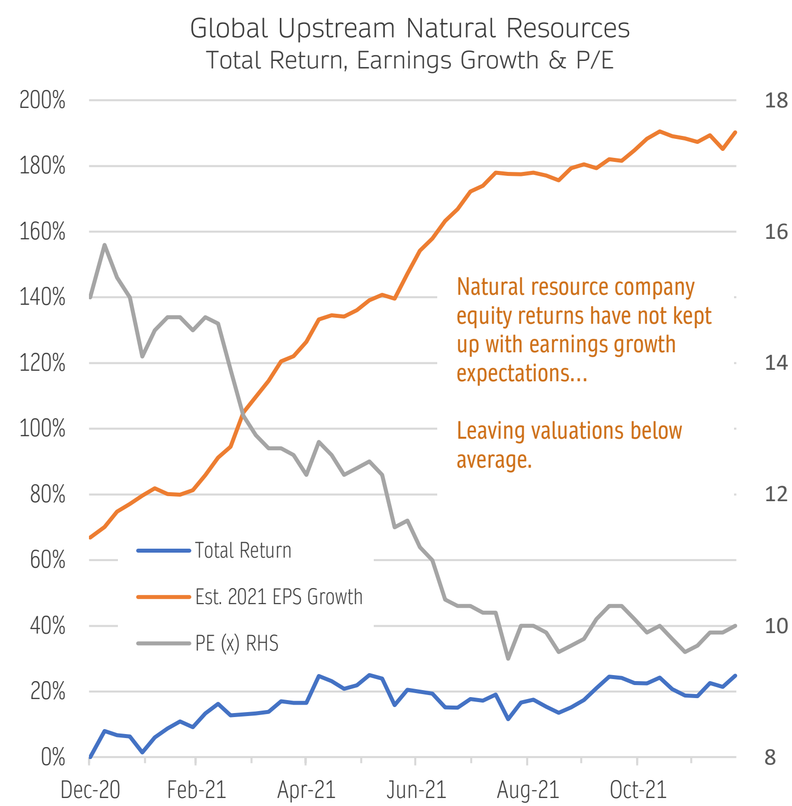
Natural resource companies are attractive in this environment as they **generate a large amount of revenue per employee, which indicates that labor is highly efficient** and there will be less pressure on margins from wage growth than for other assets.

Commodity prices, and by extension the earnings of companies that produce those assets, rose dramatically in 2021 and constitute the basic inputs needed to manufacture all goods and transport those goods.

However, the **equities of companies that produce those commodities have not kept up with the sky-high prices of the commodities themselves**, even as earnings estimates have been revised up over the year. Valuations (estimated value based on cash flow and the growth rate of a company) sit at 9.9x vs. the 10-year average of 13.9x.

Commodities are the most volatile asset class employed in portfolios, and high prices now are encouraging suppliers to ramp up production, which will stabilize or lower prices in 2022. So given our expectation for higher volatility than 2021, stabilizing prices in the futures markets, and natural resource equities lagging their respective commodity futures price, the **addition of natural resource equities is expected to leave more room for positive return.**





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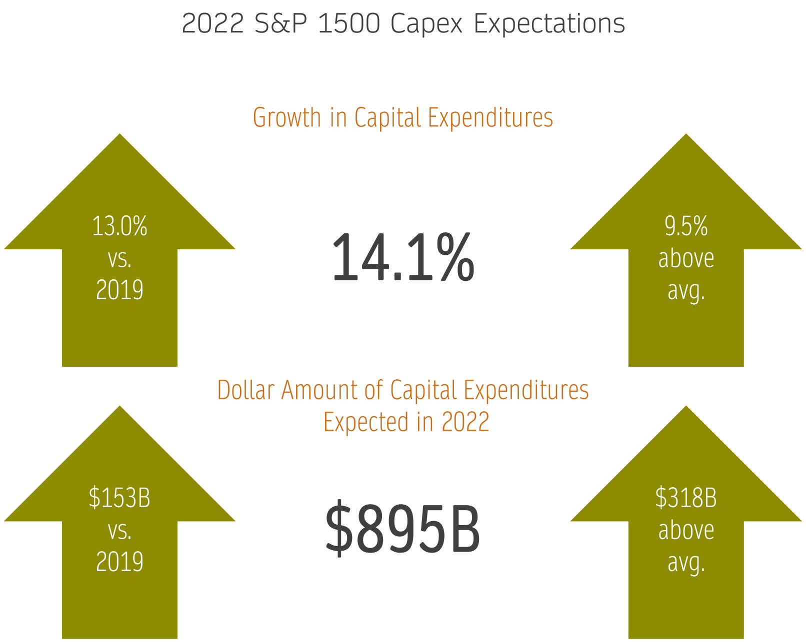

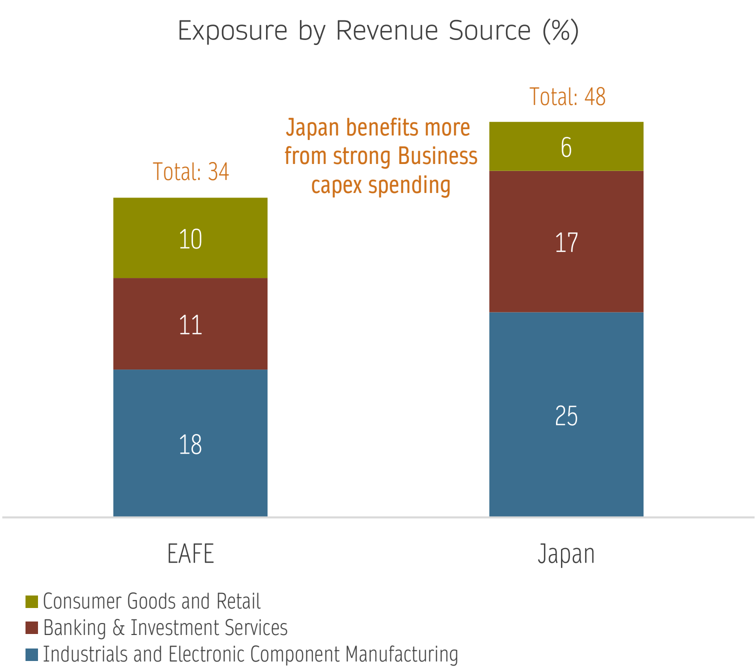

Source: FactSet

Follow the Money

Companies are responding to the supply chain and labor availability issues by broadening their supplier base, localizing the supply chain, and investing in technology to improve overall productivity. Surveys of CFO's indicate that technology spending plans are close to a record high. We **reviewed our underlying positions in each of our core equity holdings to identify those funds with the heaviest exposure to sectors that should benefit from the anticipated rise in business spending.**

In that review, Japan came to the top of the list for international developed equity markets. **Japan has high exposure to business capital expenditures** and supply chain improvement spending, consumer goods and retail spending, and banking and investment services with 48.1% of public company revenue generated from the target sources.

Japan's valuations are also less stretched relative to Europe, Australasia, and the Far East (EAFE) in general and more attractive relative to U.S. large company stocks than EAFE. Finally, **Japan is also the only developed economy that has committed to additional significant fiscal stimulus in 2022.**

With economies beyond the recovery phase and into expansion, being selective about exposures will pay off. Beyond natural resource companies and Japan, we also find small companies in the U.S. and global infrastructure attractive. Remember, we should expect **modest single digit returns in 2022, so our goal is to position towards those sectors that have the largest possibility to produce positive returns given the current financial market landscape.**