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With the S&P 500 achieving fresh all-time highs a remarkable 68 times in 2021 and broad-based inflation figures remaining buoyant, on the surface it appears as though economic growth and corporate profitability are poised to soar in the coming years. Beneath the surface, however, the narrowing breadth of the stock market, the recent rotation into defensive sectors, and subdued yields in the bond market are revealing a less rosy outlook. From where we sit, the big picture story that has yet to become consensus is the looming growth slowdown and the headwinds it will likely present for risk-assets. Here we will highlight one less-discussed phenomenon - rising inventories - which we expect will contribute to a return to the same sort of muddle-along, low-interest rate economic environment we experienced in the years following the Great Financial Crisis.

A consistent thread in the history of market economies is that perceived shortages and rising prices inevitably lead otherwise sober individuals and businesses into believing that the current state of things will last indefinitely. This breeds excessive investments, production, inventory-building and, ultimately, calamity. Today, we're seeing evidence of such behavior in a wide range of sectors.

In the world of electronics, for example, semiconductor manufacturers have responded to the global chip shortage with plans to dramatically increase production. Samsung, the world's largest chip producer, plans to invest $205 billion over the next three years in new capacity, and at the same time Taiwan Semiconductor Manufacturing Co. and Intel Corp

have each earmarked over $100 billion in capex for new chips. As anyone who needed to buy or rent a car in the past year knows, the automobile industry was acutely impacted by the chip shortage. Car manufactures and rental companies were unable to restock their fleets at the same time millions were eschewing public transportation. As a result, the cost of renting a car is up 39% year-over-year, and used car prices are up 44%.

Looking to capitalize on this, car manufacturers are aggressively building capacity, repurposing supply chains and securing components to position themselves as the leader in electric vehicle (EV) production. EV's only accounted for ~4% of sales in 2021, and while this number will certainly trend higher, we believe car companies are overestimating demand for EVs and, given the complexity and uncertainty in the battery market, underestimating the difficulty of producing them at scale at a price most consumers can afford, as Tesla has demonstrated over the last several years. For better or worse, combustion engines and the oil that fuels them are not going away anytime soon. Perhaps also not being adequately discounted are the shiploads of partially-completed vehicles that will be ready to flood the lots of dealerships as soon as the computer chips arrive to complete them.

Turning to agriculture, an industry plagued by boom and bust over the decades, US farmers are expected to plant 230 million acres of soybeans, corn and wheat this year, up two million acres from last year's record levels. Prices in these commodities have surged from pre-pandemic levels due to supply chain and various weather-related issues. It's often said that the best fertilizer for corn-growing is high prices, and that certainly rings true this time around. Here, barring major

weather disruptions, we also expect inventories will continue to build until prices come down to levels more in line with their fundamentals (production cost). A major buyer of these commodities is China, a country where economic growth, which has already been slowing due to a vastly overbuilt real estate sector, is now starting to take a backseat to economic stability from a policy perspective.

In the US real estate sector, the Zillow Offers debacle served as another classic example of overly optimistic market behavior. Assuming that price increases and supply shortages would continue indefinitely, Zillow acquired properties directly from homeowners and then tried to sell them to new buyers for a quick profit. What the company failed to appreciate was how labor and materials shortages would delay the renovation work needed to flip the property. In embarrassing fashion, Zillow was forced to shut down the business and incur massive write-offs.

Lastly, on the consumer side, the latest earnings results from big box retailers Walmart, Target, TJX and Home Depot have shared one interesting feature that is uncharacteristic of a growing economy: inventories have been rising faster than sales. The likely explanation for this was that in the beginning of the pandemic, unable to spend on services, Americans pulled forward purchases of autos, new appliances, TVs and other durable goods to improve the home. "Inventories in our driveways," as some economists refer to recent durable goods purchases, are not captured in corporate balance sheets, but nonetheless have an impact on future demand for such goods, given their nature as one-time or infrequent purchases. Now that our economy has more or less reopened, we are not convinced that the rotation out of durable goods and back into service spending among households will be as robust as many suggest. Although the market seems to be

shrugging off the potential demand destruction stemming from the surge in the Omicron-variant, as of the time of this writing the US reported an incredible one million new cases in a single-day, double the rate from four days prior. Companies such as Ford, Google, and JPMorgan have pushed back their return-to-office plans, thousands of flights are being canceled daily due to Covid-related staffing shortages, and bars in major metropolitan centers have announced temporary closures.

Given these dynamics, among others, we think the Federal Reserve (the perennial elephant in the room) and its lofty 4% GDP growth forecast for 2022 is potentially making a policy mistake with the rather dramatic hawkish pivot it announced in mid-December against a backdrop of continued declining money velocity. If the Fed stays on the path it's advertising, and ultimately raises rates three times this year, we think the market may react with another "taper tantrum" as it did the last time it raised rates under its rate normalization policy in late 2018. The economy's ability to endure higher interest rates is highly questionable: today's overindebtedness and high valuations have created a fragility that has been concealed by unprecedented monetary and fiscal accommodation. As the Fed's bond buying program and any hope of an organized, constructive fiscal stimulus package fade, we suspect the most speculative areas of the market (cryptocurrencies, big tech, clean energy, SPACs) will be the most challenged, and at the same time stocks in high-quality, dividend-paying companies that are less reliant on strong, broad-based economic growth will become increasingly attractive. With our emphasis on stocks in healthcare, utilities, and consumer staples, our portfolios continue to carry the sort of defensive bias that tends to excel during periods of slowing growth and central bank tightening.

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