SEGALL BRYANT & HAMILL

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SBH NEWSLETTER

Thoughts on the Current Environment

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"Two years ago, we were facing COVID, virtually a Great Depression, a global pandemic, and that's all in the back mirror, which is good," Mr. Dimon said on a conference call. "Hopefully a year from now there will be no supply chain problem. The pandemic will become endemic."

—Jamie Dimon, *JPMorgan's Jamie Dimon Says Pandemic Is Moving to the Rearview Mirror,* Wall Street Journal, Oct. 13, 2021

Some Random Thoughts in a Fragmented Environment

Our goal in each edition of the *Quarterly Review* is to develop an overarching theme on a topic in the world of economics and/or finance that we hope will help our clients better understand how we are trying to navigate across uncertain terrain. In this issue, however, what follows are some reflections on issues that affect the global economies and markets that may well be interconnected, but in ways that are not readily apparent. Nonetheless, they seem worthy of comment.

On the Road to Normal

We begin Year 3 of the COVID era, also known as 2022, possibly in the best shape we have been in since the pandemic began, despite a barrage of bad news about the explosive growth of the current variant, Omicron. As the new year begins, we are trying to learn whether this new variant could prove to be the Omega for COVID. Omicron appears to be more highly transmissible than Delta, but it also appears to be less lethal. If that proves to be the case, then we have a COVID variant that will likely displace the other versions, infecting many but killing fewer. As a result, those who do not want to be vaccinated will ultimately acquire immunity by contracting and then recovering from the disease. In so doing, they will then join the ranks of those who opted to use vaccines to acquire the same immunity. At that point, COVID will not be able to bring the global economy to its knees ("pandemic"). Instead, we will find a path towards accommodation with which we can return to what we think of as "normal."

What do we mean when we say return to normal? Pre-COVID, we contended with a persistent (endemic) virus, one of the same family that caused the Spanish flu pandemic in 1918. Upwards of 50,000,000 people died in that pandemic, as it raced around the globe, pretty much unimpeded for two years before the virus finally burned itself out. While its descendants are much less lethal, it is worthwhile recalling that in the most recent decade, using just the experience in the U.S., there have been roughly 39 million cases per year of *"the flu"* resulting in the deaths of approximately 34,000[1] people each year. Nevertheless, beyond getting a flu shot every year, we lead unconstrained lives. The CDC estimates that about half of American adults get vaccinated each year for the flu. No lockdowns, no travel restrictions, no school closures. The flu is endemic in our lives, and we simply move onward, taking the flu and the annual fall flu shot in stride. What if Omicron is not the solution? Expect another year of uneven and irregular economic growth and activity. But the history of viral mutations suggests that the pathway described above is the common pattern and our technological expertise will ultimately develop, if not a 100% effective vaccine, better treatments to deal with those who do become infected.

A Real Estate Bubble—Old Story, New Location

China may well be the wild card for the global economy and the financial markets in 2022, more so than ever before. As with the West's expansion in 2009, the bill for China's great expansion, largely the product of too much investment in real estate, is starting to come due. Unlike the West, which overbuilt too many residential projects, China overbuilt too many cities. Whether an economy is organized as capitalist or communist, the rules of supply and demand still prevail. Similarly, the risks of taking on too much debt, and the consequences of not being able to pay the lender back, similarly prevail. The recent failure of the Chinese real estate firm Evergrande is simply the first shoe to drop. Recall that in March 2007 Bear Stearns announced the collapse of two hedge funds it sponsored that invested in sub-prime mortgages a year before the firm itself failed. That was also 18 months before September 2008, by which time the Global Financial Crisis had infected and threatened the solvency of the global banking system, culminating ultimately in the failure of Lehman Brothers.

Some might argue that the default of a corporate entity and the default of a government are two separate issues; after all, a government cannot go bankrupt. As Rogoff and Reinhart showed in their 2009 book, *"This Time Is Different,"*[2] such things can and do happen. For instance, Argentina has defaulted on multiple occasions in the last 100 years. China is undergoing a significant downshift in economic activity because of the debt overhang that was created in the wake of the long-running expansion. The Chinese government will probably choose different pathways to address the problem than the West did, but all roads will lead to the same outcome. The cost of dealing with the self-inflicted excesses are going to be about the same for them as it has been for the West, lasting the next several years or longer. Who winds up bearing the losses—the Chinese government, Chinese investors, or foreigners (mostly Western banks and insurance companies)—is a serious subject, one worthy of discussion on its own. For us at this moment, however, the significance is this: whatever global growth rate was assumed for 2022, it is likely to be lower than earlier thought because China

[1] *Figure is average of annual cases from 2010 to 2020; taken from Flu Vaccination Coverage, United States, 2020–21 Influenza Season | FluVaxView | Seasonal Influenza (Flu) | CDC.*

[2] *Carmen M. Reinhart and Kenneth S. Rogoff, "This Time is Different, Eight Centuries of Financial Folly," Princeton University Press, 2009.*

(or the West) will not be able to achieve the same rate of growth it has in the past, hobbled by the burden of servicing debt that was taken on in the expectation that the investments undertaken would generate more than sufficient income to service it.

The Consequences Could be More than Economic

One consequence of a significant slowdown in China is political turmoil. Consider the political unrest created by the financial crisis of 2008, which has led to extreme swings in electoral preferences and led multiple changes in government. Democratic by nature, the West (Europe, the U.K., Canada, and the U.S. among others) has experienced these changes in spirited elections, to be sure, but ones that have been accepted by all. This will not be the case in the totalitarian regime that is China. There is no safety valve for pressures arising from public discontent such as are available in the West with the ability to express displeasure at the ballot box. One approach that governments facing popular unrest have historically chosen is to divert attention from internal problems by focusing on an external "enemy". In this case, the most consequential choice to the global economy could be greater Chinese focus on Taiwan. Taiwan is to the global economy today what Saudi Arabia has been since the first Arab Oil Embargo in 1973. In the Saudi case, it was oil. For Taiwan, it is semiconductors. Armed conflict, which could destroy or disrupt productive capacity of either product, would cripple the global economy for a prolonged period. The world would limp along if the pumping and gathering systems of the Saudi oil fields were ever materially damaged. Many other countries can produce oil and would step up as much as they could, but the impact would be material. Similarly, not all global semiconductor fabricating facilities are in Taiwan, but the supply shortages we have endured since the pandemic are a glimpse of what could happen if China were to miscalculate or move too aggressively in pursuit of bringing "its runaway province" back into the fold of the mainland.

The Genie is Out of the Bottle

Inflation accelerated dramatically in 2021. Having been wrestled back into a bottle by Paul Volcker, who became the Chair of the Fed in 1979, the inflation genie has been quiet for the last 35 to 40 years. Unconstrained growth of the money supply in the period after the financial crisis, with no corresponding efforts to undo excessive growth in the years following, left the monetary authorities with no fully recharged tools to fight the financial crisis that arose with COVID. With little or no flexibility, central bankers resorted to printing even more money but with no long-term plan in place for ultimately removing the excess. As a result, it appears that a new round of inflation has bloomed globally in the aftermath of COVID. Milton Friedman, a Nobel Laureate in Economics, famously said that inflation was forever and always a monetary phenomenon, but it is also a state of mind. If people think there is too much money chasing a smaller supply of goods, real or feared (think toilet paper during the first pandemic outbreak), they will be willing to pay more to avoid higher prices in the future.

Why should we care about inflation? For several reasons. Inflation is an illusion in terms of making people feel they are better off when in fact they are probably at best treading water. Second, inflation penalizes savers, by reducing the value of the dollars they receive either in interest or in returns on capital. In turn, savers will begin to demand higher yields to compensate them. For the governments of the world, with massive debt burdens to carry, the costs of borrowing new funds—just to keep pace—at higher interest rates will cause great stress on government budgets. Higher deficits will be the result. Further, higher interest rates will (eventually) weigh on stock prices as higher rates will inevitably cause investors to sell stocks to buy bonds that are finally yielding sufficiently high returns. And, finally, there is a wild card to consider. Other than some old fogies who don't count, no one who really matters has lived through inflation, whether we are thinking of investors, Federal Reserve governors, or corporate managements. Wrestling inflation back into the bottle is not easy once it is out, and a new generation of decision makers has to learn this. They won't learn easily or quickly, and a lot of eggs will be broken in the process. All of this raises more risk to a financial system that really does not know the meaning of "risk." It really is a four letter word.

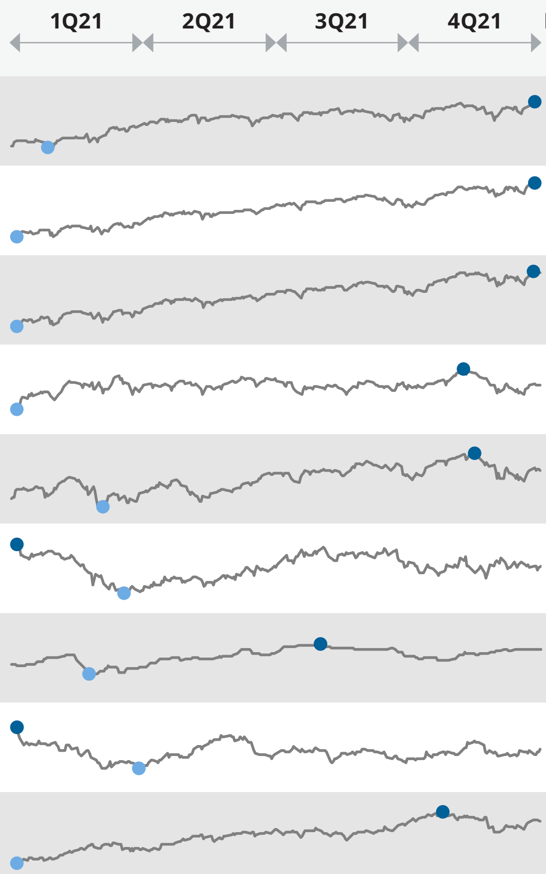
Whew!

Investors enter 2022 flush with several strong years of returns from the financial markets, paradoxically achieved during tremendous political and social turmoil. We have been concerned about very high valuation levels for stocks and low levels of interest rates in the bond market which are now in real, that is, inflation-adjusted terms, quite negative. While the opportunity set seems to be getting smaller and smaller, the fact that the markets remain high illustrates the comment attributed to J.M. Keynes: "The market can stay irrational longer than you can stay solvent."

We wish you a safe and healthy 2022. Our goal for 2022, as always, is to steer your portfolio through turbulent waters to a calm harbor where a fruity beverage awaits, spruced up with something strong, or not, as is your preference.

MARKET BAROMETERS

AS OF 12/31/21



	Jan. 4, 2021	Dec. 31, 2021	Low	High
Dow Jones Industrial Average®	30,223.89	36,338.30	29,982.62	**36,488.63**
S&P 500® Index	3,700.65	4,766.18	3,700.65	**4,793.06**
Russell 3000® Index	2,215.42	2,788.14	2,215.42	**2,803.74**
Russell 2000® Index	1,945.91	2,245.31	1,945.91	**2,442.74**
Russell Midcap® Growth Index	1,631.28	1,857.71	1,563.84	**1,987.87**
Bloomberg US Aggregate Bond Index	2,390.63	2,355.14	2,304.57	**2,390.63**
Bloomberg Municipal Bond Index	1,338.58	1,358.14	1,324.39	**1,364.36**
Gold (Price/Oz) London AM Fix	1,930.80	1,820.10	1,685.35	**1,957.20**
S&P-GSCI Commodity Index	1,970.19	2,774.73	1,970.19	**2,940.41**

Source: Bloomberg.

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