CHIEF INVESTMENT OFFICE

Investment Insights

Seeing the Forest For the Trees: Investing For the Future

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Sometimes the most difficult thing to do in investing is to look past the present and plan for the future. That is especially true given today's tumultuous investment environment.

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CIO VIEWS

With great resets come great opportunities—and capturing these opportunities requires that investors not get caught up in the day-to-day, short-term ebb and flow of the market. Rather, investors need to see the forest for the trees.

Just in the past few years, the world has had to grapple with a natural healthcare disaster, a new "cold" war, unprecedented monetary easing, new fiscal relief plans, a multidecade spike in inflation, global supply chain disruptions, constrained labor markets, and extreme volatility of commodity prices. Through it all, corporate America has been incredibly resilient, adjusting to shifting circumstances with dexterity and deftness that has, in general, sustained profit growth so far. Most recently, four-decade-high inflation and the onset of extraordinary tightening of financial conditions have created more uncertainty in what lies ahead, including the ultimate trajectory of corporate profits.

The Chief Investment Office (CIO) likes to characterize this post-pandemic volatile period as *The Great Reset*. A reset in interest rates, yields, valuations, and potential game-changing resets in geopolitics and climate change. Rarely has the investment environment been so fluid. However, with great resets come great opportunities—and capturing these opportunities requires that investors not get caught up in the day-to-day, short-term ebb and flow of the market. Rather, investors need to see the forest for the trees.

In our view, it's not whether we are "at or near a peak" in the stock market, whether the Federal Reserve (Fed) will hike further, or whether we are heading into a growth scare or normal recession. More relevant is for investors to navigate uncertainty by taking a long-term approach and by maintaining a disciplined and diversified portfolio while actively rebalancing asset classes and an understanding that timing the markets has historically been an unsuccessful strategy.

To gain a better understanding of this thought process, we briefly examine below key historical periods of major crisis and recovery. We then turn our lens to the future.

The Long View

A look at the past 100 years shows several periods of societal, economic, geopolitical and financial difficulty that would eventually give way to new patterns of activity, innovation, policy support and cooperation that were more constructive for households,

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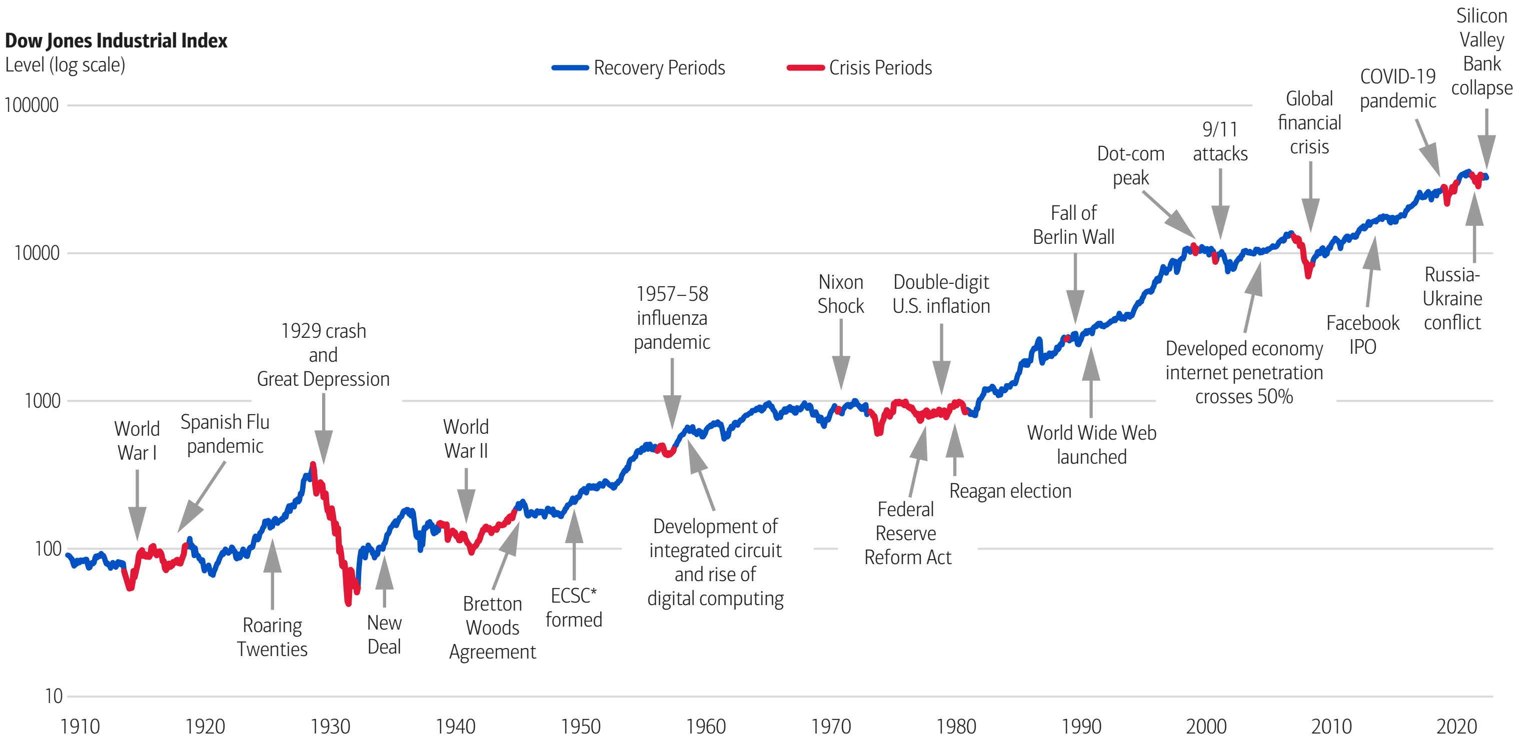
companies and investors. The early 20th century, for instance, included a world war and a global flu pandemic. The 1930s saw an economic depression and military conflict on an even larger scale. The 1970s was a period of economic stagnation and high inflation. The first decade of the new millennium brought the collapse of a stock market bubble, the rise of global terrorism and a financial crash. Crucially, each of these historical crisis periods was ultimately succeeded by an economic revival, a more favorable investment environment and sustained price gains for equity markets (Exhibit 1).

Exhibit 1: Equity Market and Historical Periods of Crisis and Recovery.



Source: Chief Investment Office, Bloomberg. Data as of June 2023. *European Coal and Steel Community. **Past performance is no guarantee of future results. It is not possible to invest directly in an index.**

In the first half of the 20th century, the turmoil of the 1910s—notably World War I and the Spanish influenza outbreak—was followed by the Roaring Twenties, a period of widespread consumerism in the U.S. and Europe driven in large part by innovations in telecommunication and manufacturing that had supported the war effort. These included new devices such as the telephone and the radio, as well as mass production techniques like the moving assembly line which made electronics, automobiles and other consumer products more affordable to individual households. Over the same period, the equity market delivered outsized annual returns in excess of 20%.

The global economic boom of the 1920s then came to an end with the Wall Street crash of 1929, the start of the Great Depression and, eventually, World War II. But the economic turbulence and global conflict of the 1930s and early 1940s nonetheless gave way to a much more benign environment for economies, markets, geopolitics and policy in the post-war years. The effects of the Great Depression led to a rash of New Deal regulations and programs designed to prevent a recurrence of the extreme economic stress of the period under agencies such as the Securities and Exchange Commission and the Federal Deposit Insurance Corporation. The hostilities of World War II were replaced by a new period of global cooperation on trade, monetary and exchange rate policy under the Bretton Woods system. And the post-war years also brought major gains in innovation and the wider economy with the development of the integrated circuit and dawn of digital computing, the baby boom and the expansion of the middle class across industrialized economies.

The 1970s by contrast was a prolonged period of economic stagnation and high inflation—or stagflation—with negligible market returns. However, once again the economic malaise of the 1970s was followed by a shift toward more pro-market government and monetary policy, and a period of much stronger investment performance in the 1980s and 1990s. A surge in the international labor pool, driven primarily by China and the former Soviet Union, accelerated the trend toward globalization, allowing large corporations to extend their supply chains to lower-cost countries. At the same time, ongoing cost reduction and miniaturization in electronics saw the rise of the personal computer in the 1980s, followed by the emergence of the commercial internet in 1990s, with the dot-com boom in the second half of the decade providing an additional tailwind for global markets.

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Major periods of upheaval, in other words, can be triggers for economic regeneration, and we expect a similar pattern of renewal to emerge from the current crisis.

Serial crises for financial markets in the form of the Dot-com bust of 2000, the 9/11 terror attacks, and the Global Financial Crisis of 2008 made for negative Equity returns in the 2000s as a whole. But an aggressive global monetary and fiscal response would eventually restore stability to financial markets. And after the string of crises that had occurred over the course of the decade, the global economy went on to register its longest span of continuous growth of the post-war era between June 2009 and March 2020 alongside double-digit returns for equity markets (Exhibit 2).

Exhibit 2: Historical Periods of Crisis and Recovery.

Crisis Period	Post-Crisis Recovery	Post-Crisis Equity Return (annualized)
World War I, Spanish Flu pandemic	1920-1929: Roaring Twenties, mass production, boom in media, entertainment, consumerism	+21.2%**
Great Depression, World War II	1945-1969: New investor and consumer protections, global cooperation on trade, monetary and exchange rate policy, Keynesian revolution*, dawn of digital computing, middle class expansion	+7.2%**
1970s stagflation	1980-1999: Central bank independence, disinflation, structural interest rate decline, de-unionization, privatization, lower tax rates, rise of global labor force, rise of personal computer and commercial internet	+13.4%***
Dot-com bust, 9/11 attacks, global financial crisis	2009-2019: Global monetary and fiscal expansion, ongoing increase in digital penetration, rise of mobile internet and new online services	+11.2%***

Sources: Chief Investment Office; Bloomberg. Data as of August 2022. *Keynesian economics are the various macroeconomic theories and models of how aggregate demand strongly influences economic output and inflation. **Dow Jones Industrial Average Index price return. ***S&P 500 Index price return. 1920-1929 price peak. **Past performance is no guarantee of future results. It is not possible to invest directly in an index.**

The digitization of the global economy has perhaps been the most significant investment theme of the past decade, particularly the emergence of the smartphone and the growth of the mobile internet. Social media, digital advertising, internet retail, video streaming, ride hailing and other online services have driven the explosive growth in the sector over the past 10 years and will likely remain drivers of future growth in the post-pandemic era.

The key lessons from these past episodes is that it is important in times of disruption to recognize emerging new trends that may be obscured by the immediate crisis fallout, but which nonetheless have positive implications for economic output, market returns and asset allocation strategies. Major periods of upheaval, in other words, can be triggers for economic regeneration, and we expect a similar pattern of renewal to emerge from the current crisis.

As for the numbers, in the post-war period overall between 1945 and 2021, the S&P 500 has delivered an annualized total return of 11.6%, well in excess of the average annual gains for corporate credit (6.2%), government bonds (5.3%), cash (3.8%) and inflation (3.7%).

On to the future: New Drivers of Growth and Market Returns

As we look forward into the post-pandemic era, we see a range of structural forces helping to sustain another period of long-term gains for U.S. equity markets. Some of these key drivers include:

Digitalization

The digital economy has shifted into overdrive owing to greater means of connectivity, more global internet users, falling costs, and advances in artificial intelligence and related innovations. The coronavirus pandemic, meanwhile, only accelerated this trend as both businesses and households adopted to a more remote world, spurring growth in telemedicine, e-commerce, online education, mobile banking, and related activities. From our perspective, this new frontier should be particularly beneficial for related sectors such as information Technology, Communication Services, Consumer Discretionary and Healthcare. And with the most exposure to these areas, the U.S. equity market remains well placed to further outperform the rest of the world.

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Meanwhile, the acceleration in the uptake of these new online services should only increase the need for investment in next-generation 5G telecommunications infrastructure, cloud computing, and increased Artificial Intelligence capabilities and services. As the digital economy commands a larger share of global output, this improvement in network reliability, speed and capacity will be critical in supporting a larger number of wireless connections consuming ever larger amounts of data over the years ahead.

Global healthcare spending

The pandemic of 2020 revealed major shortfalls in capacity across healthcare systems around the world, both in emerging and developed economies, and this highlights a fundamental lack of preparedness not only for medical emergencies, but also to meet growing demands over the coming years from ageing populations and rising incidence of chronic disease. We therefore expect spending on healthcare infrastructure to increase globally over the years ahead as medical service providers look to build demand-surge capacity for diagnosis, treatment and monitoring.

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Healthcare expenditure has remained relatively stable at 9% to 10% of global gross domestic product (GDP) over the past several years and the pandemic is likely to bring forward much-needed investment in medical equipment, healthcare facilities and advanced drug development techniques. Greater reliance on telehealth is likely to be among the key solutions to emerge from the crisis. And biosecurity practices should also gain in adoption over the period ahead. These are measures aimed at mitigating biological threats from pathogens, such as stricter regulations around sanitation, new health-related screening policies for entry into buildings or the use of contactless payment methods.

The acceleration in automation

The localization of supply chains, chronic labor shortages, rising labor costs—all of these variables and others—have accelerated the pace of automation in manufacturing and service operations. This means faster adoption of robotics and new techniques such as 3D printing across various sectors of the economy, ranging from Finance and Agriculture to Manufacturing and Retail. In the latter, the number of cashierless stores is already on the rise and this is a trend that should be reinforced. Growth in service robotics is expected to soar over the next decade, and help create potential investment opportunities among leading firms in electrical equipment and instruments, application software, artificial intelligence and communication services.

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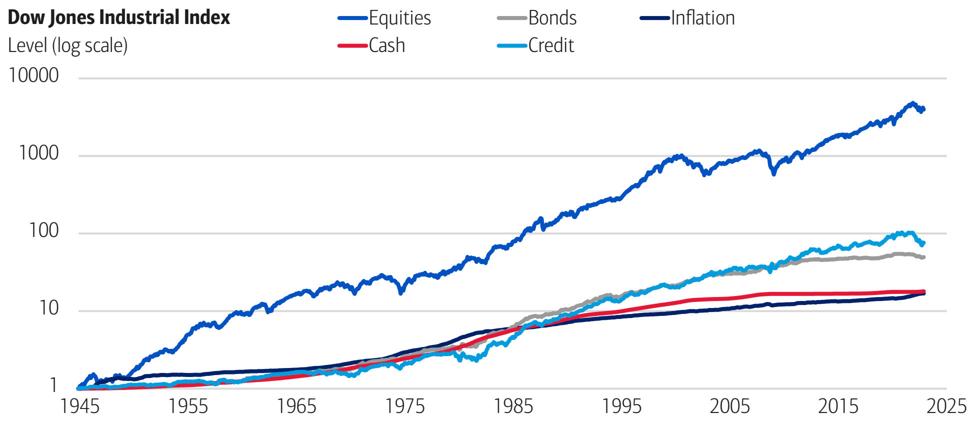
Investment conclusions: A new phase and new opportunities for long-term investors

The current investment environment is shrouded in unknowns as the world struggles to contain elevated inflationary pressures, the aftershocks of the pandemic and the military conflict in the heart of Europe. Uncertainty is the staple of our times. Yet, widening the lens and taking the long view, market returns are never linear and prone to periodic bouts of volatility. For stocks, the best recipe for loss avoidance has been time. (Exhibit 3).

Exhibit 3: Equities Have Significantly Outperformed Other Asset Classes In The Post-War Era.



*Estimate. Sources: Morningstar Ibbotson; Bloomberg, Barclays Live. Data as of 2022. Equities are S&P 500 total return; Bonds are Intermediate U.S. Treasurys; Credit is long Corporate credit; Cash is 30-day Treasury bill; Inflation is U.S. consumer price index. **It is not possible to invest directly in an index. Past performance is no guarantee of future results. Please refer to index definitions and important disclosures at the end of this report. Past performance is no guarantee of future results.**

A key lesson from post-war history is that bouts of instability and market selloffs have been followed by multidecades of rising returns as the economy resets and regenerates a new cycle of growth in corporate earnings. Indeed stocks have significantly outperformed other asset classes over time, returning an annualized 11.2% between 1945 and 2022—well ahead of bonds (5.1%), credit (5.7%), cash (3.8%) and inflation (3.7%) (Exhibit 3). As we look ahead, we believe we are at the cusp of a new cycle of upside market returns, backstopped by the accelerating pace of digitalization, the primacy of healthcare, increased automation and the global push for a greener future. Think of these factors as powerful structural tailwinds for future long-term earnings growth. As the reset fades and the private sector develops a new profits cycle, investors can gain exposure to various decade-long growth drivers through broad U.S. index exposure, specific sector emphasis, and/or direct portfolio exposure to individual companies aligned with specific themes. In the end, what matters most, in our view, is that the Equity asset class (more specifically the U.S.) in general tracks the direction of the profits cycle. As a new profit cycle builds, we expect Equities to undergo another robust bull market period.

> We favor an approach that involves a longer time horizon, detailed planning, a disciplined and diversified portfolio construction approach, defined rebalancing targets and an understanding that timing the markets has typically been an unsuccessful strategy for investors over the long term.

One point on valuation. We can all debate a single point estimate of what valuation should be. But assessing valuation in the context of one period or even relative to history misses another major foundational principle of investing in our view. Investing should occur over time not at a point in time. Investing over time allows for a more “smoothed” valuation level while new innovations and growth-inducing tailwinds mature through their own life cycles. This should ultimately help to compound returns at a more attractive rate. Valuation is clearly important, but the actual level can change in a heartbeat depending on a variety of ever-changing factors.

Maintaining a disciplined, long-term approach to investing will perhaps be more important now than ever before. While today's high-speed access to information around the clock and around the world can create the impulse for investors to move in and out of markets more frequently, we believe that through the episodic volatility, fundamental drivers are providing long-term directional support for stocks.

We therefore favor an approach that involves a longer time horizon, detailed planning, a disciplined and diversified portfolio construction approach, defined rebalancing targets and an understanding that timing the markets has typically been an unsuccessful strategy for investors over the long term. We favor investing through the emergence of new growth cycles in order to capture the benefits of total return as valuations ebb and flow. More often than not, this type of environment tends to occur after major reset periods.

Despite the tall list of short-term unknowns, we believe the future is bullish. Develop a plan and invest now for the future.

Index Definitions

Securities indexes assume reinvestment of all distributions and interest payments. Indexes are unmanaged and do not take into account fees or expenses. It is not possible to invest directly in an index. Indexes are all based in U.S. dollars.

Equities/S&P 500 (Total Return) Index includes a representative sample of 500 leading companies in leading industries of the U.S. economy. Although the index focuses on the large-cap segment of the market, with approximately 75% coverage of U.S. equities, it is also an ideal proxy for the total market.

Dow Jones Industrial Average Index is a stock market index of 30 prominent companies listed on stock exchanges in the United States.

Bonds/Bloomberg Intermediate U.S. Treasury Index measures US dollar-denominated, fixed-rate, nominal debt issued by the US Treasury with maturities of 1 to 9.9999 years to maturity.

Credit/Bloomberg Long Corporate Credit Index is a float-adjusted version of the US Long Government/Credit Index, which tracks the market for investment grade, US dollar-denominated, fixed-rate treasuries, government-related and corporate securities.

Cash/Ibbotson 30-day Treasury Bill Index measures the performance of one-month maturity US Treasury Bills.

Inflation/U.S. Consumer Price Index measures the overall change in consumer prices based on a representative basket of goods and services over time

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