LNWM Quarterly Commentary – Q1 2022

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2022: A Year of Transitions, Change and Evolution

> "Heraclitus, I believe, says that all things pass, and nothing stays, and comparing existing things to the flow of a river, he says you could not step twice into the same river"
>
> **– Plato**

In reflecting on 2021 and considering the landscape for 2022, the preface to each of the Four Questions posed during Passover seder kept popping into my mind – *Ma Nishtana* or "Why is tonight different from all other nights?" In this context, "Why and how is 2022 going to be different than 2021?"

Transition Catalysts

As long-term investors and not Wall Street forecasters, we tend to think in terms of "market regimes" – extended time periods during which markets are dominated by certain persistent characteristics. Interestingly, there is no standard definition of market regimes in the investment arena but there are examples of market regimes that most can agree on: bull vs. bear markets, high vs. low volatility environments, high vs. low inflation, high vs. low interest rates, growth vs. value outperformance. You get the picture.

The inflection point marking a transition from one market regime (or environment) to another, and the new regime's characteristics can only be discerned in the rearview mirror. With that said, we see six potential catalysts for an inflection point from the current regime, which is characterized primarily by low inflation, low interest rates, growth over value, and trade globalization.

#1. Covid-19: Does the pandemic become an endemic and how do we adjust?

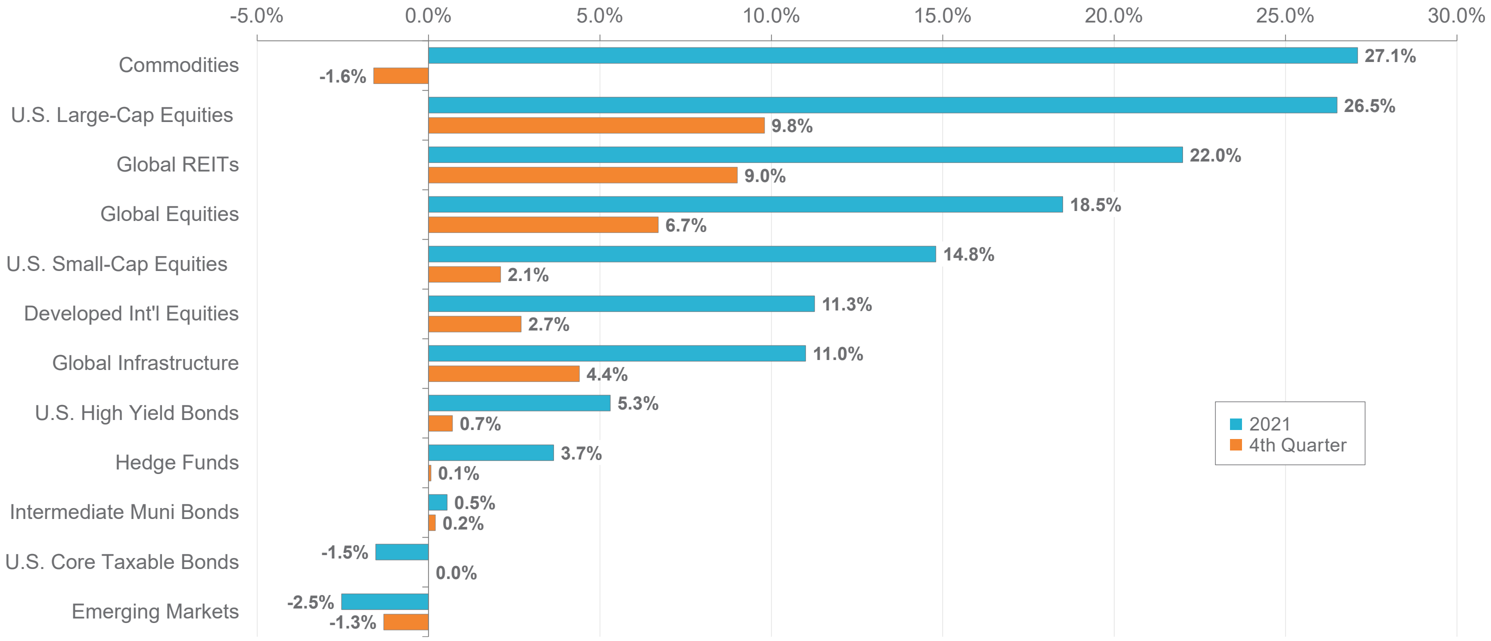
There is a case to be made that the highly transmissible Omicron variant of Covid, combined with vaccine boosters and early treatments, could create the herd immunity we need to transition from a pandemic to a more manageable endemic state. Emergence from the war on Covid could resemble an economic boom typical of post-war periods. Whether that has already been priced into risk assets remains to be seen.

Even if we continue to battle Covid as we did in 2021 (absent a new variant that is more pernicious), the global economy has demonstrated its resilience in the face of the virus. The wild card in this latter scenario is continued tightening of US monetary policy, which could lead to slower growth. Slower growth and supply-driven inflation would lead to stagflation -- not a baseline scenario but possible.

LOOKING FOR VALUE IN 2022

One of the most notable outcomes of 2021 was the torrid pace of appreciation in US large-cap stocks, which generated a third straight year of high double-digit gains (+29% in 2019, +16% in 2020, +27% in 2021), despite multiple Covid variants, supply chain disruptions, and labor dislocations just to name a few[1].

Performance of Asset Classes: Year 2021 & 4th Quarter
(As of Dec. 31, 2021)

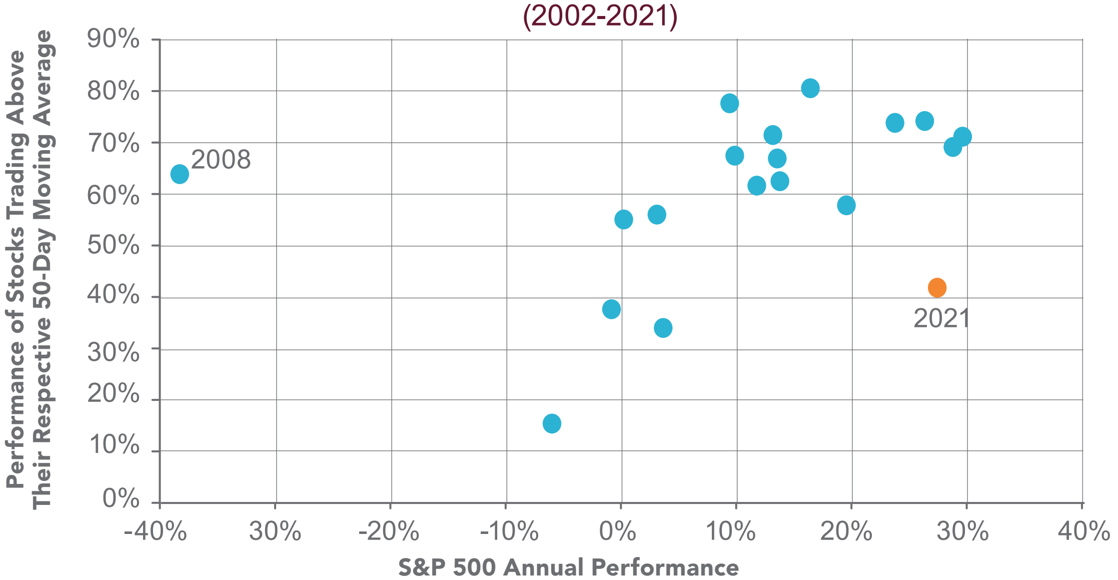


Source of Data: Morningstar, Bloomberg, Hedge Fund Research, ICE Data Services.

But looks can be deceiving. In 2021, five of the biggest US tech companies generated 62% of the gains in the S&P 500. What's more, if you remove from the global stock index (the MSCI ACWI) the 300 largest US growth stocks, the 2021 return sinks from +18% to just +1.6%[2]

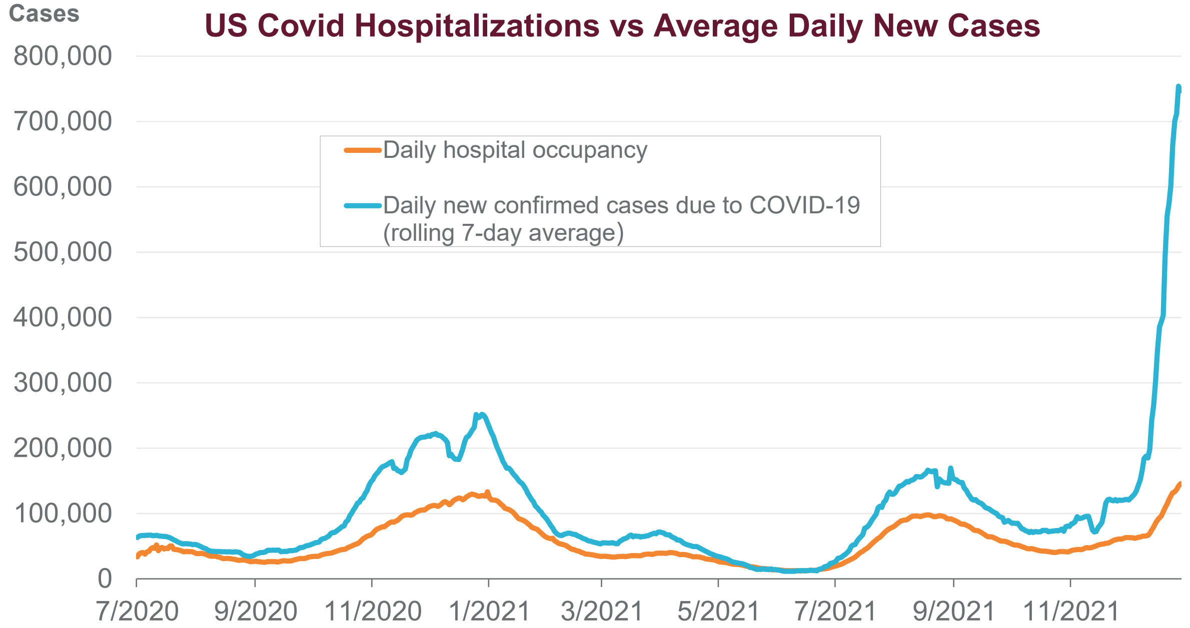
When markets are driven up by a narrow list of stocks ("lack of breadth"), this could indicate underlying weakness leading to a broader sell-off. It also could indicate, however, that the overall market may not be as overvalued as pundits report, as "the market" is comprised of thousands of companies, globally, many of which have not experienced parabolic rises in their stock price and could offer strong fundamental value.

S&P 500 Annual Performance vs End-of-Year Market Breadth
(2002-2021)



Source: https://drduru.com/onetwentytwo.

1. Source: Bloomberg.
2. Source: Narrowing equity market breadth may signal a "market top" -Bank of America.



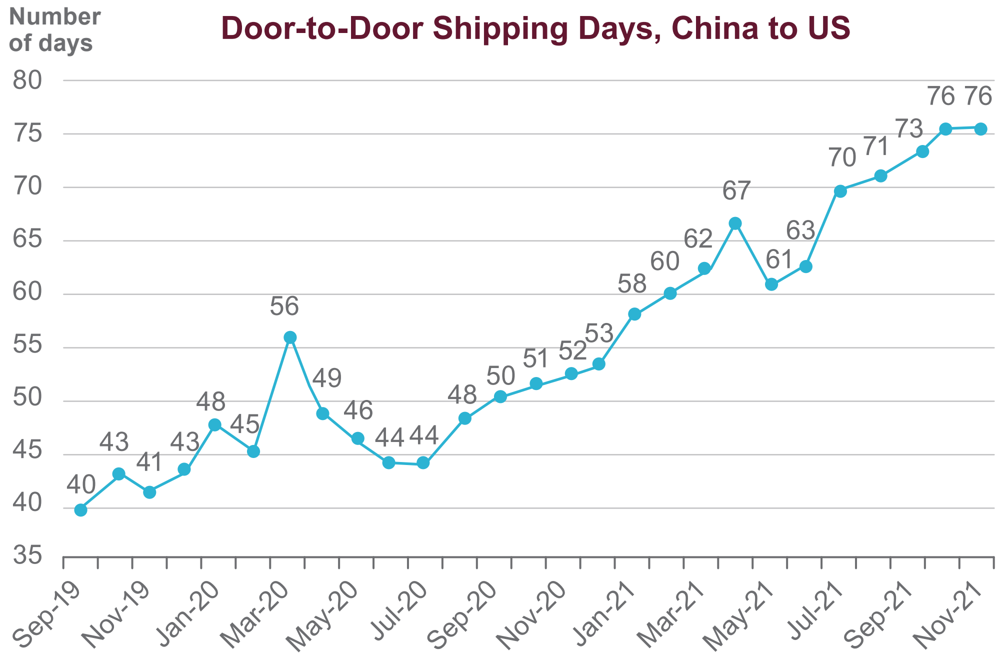
Source: Worldometers.

#2. Supply Chains: Will fractured supply chains continue to hamper the global economy, and will there be intermediate to long-term implications?

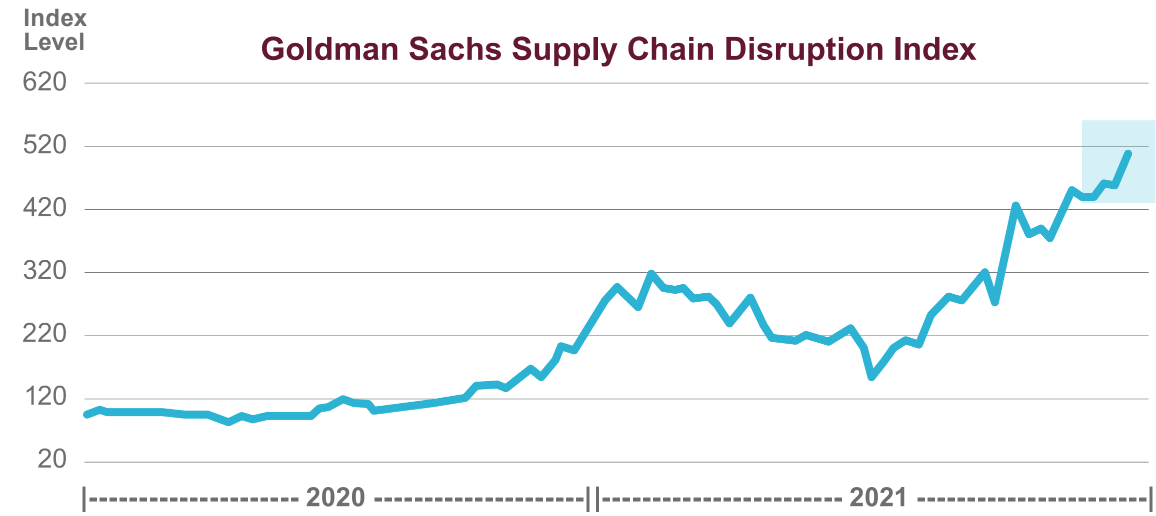
Supply chains comprise an intricate set of hundreds if not thousands of interrelationships globally (as our mapping out of Dell's supply chain showed in our Oct. 2021 client webinar). As such, we have been of the mindset that repairing supply chains would take quite a bit of time, effort, and investment.

Elevated prices and challenges in acquiring items such as automobiles are a result of a mismatch of supply and demand, with supply suffering from dysfunction and demand boosted by stimulus and above-trend nominal wage growth, especially for lower-paying jobs.

The supply chain issues should eventually get resolved, but will demand continue to outstrip supply in an economy not hobbled by Covid (a post-war boom type scenario that is in and of itself a new regime)? As we remarked in last quarter's comments, we consider inflation driven by economic growth and consumer demand to be good inflation and thus good for markets. Longer term, the recent disruptions could be a positive for the US as they



Source: Freightos, Goldman Sachs.



Source: Goldman Sachs.

have been a clarion call to corporate executives to rethink and reengineer supply chains. This could create new economic growth opportunities domestically (over the long term), including but not limited to bringing production back to the US, especially in sectors deemed critical to national security such as semiconductors and pharmaceuticals.

#3. Inflation: Have we transitioned into a higher inflation regime and will inflation expectations become anchored to a higher level?

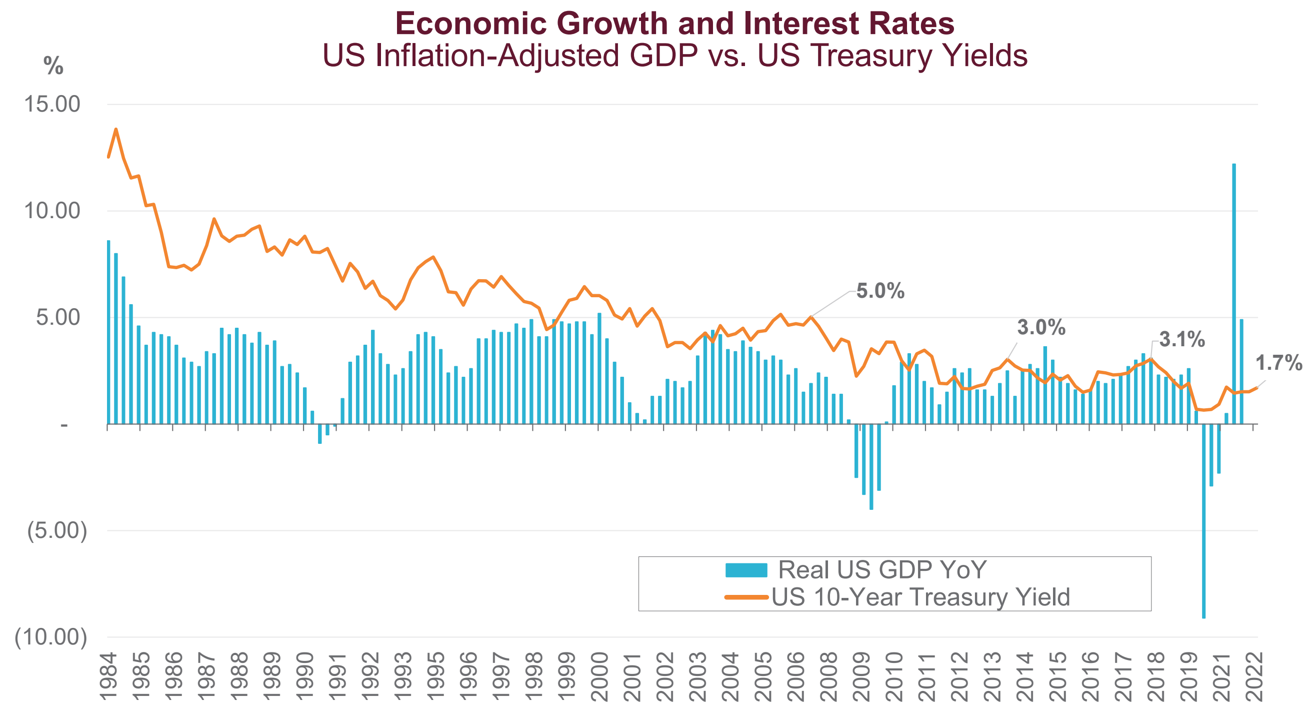
I have been writing about the tug of war between inflation and deflation for the past 15 years so why stop now? While inflation has proven to be more persistent than anticipated, the jury is still out regarding whether we have exited a low-to-moderate inflation regime. We have seen inflation "head-fakes" in the past. Inflation hit levels of nearly 6% annualized in 2008 during the Great Financial Crisis only to resume the low inflation trend in 2009. During the Spanish Flu pandemic (Feb. 1917 – April 1920), inflation soared into the double-digits but plummeted in 1919 and remained low throughout the next decade.[3] We could experience something similar given ongoing deflationary trends, such as aging populations in the developed world, significant and mounting indebtedness, widening income inequality and technological advancements just to name a few. Regardless, it is fair to say we have been experiencing a cyclical upturn in inflation; it remains to be seen whether this becomes structural.

One of the greatest risks to higher inflation becoming structural is psychological on two fronts—workers and consumers getting anchored to the idea that inflation will be higher, and corporations realizing they can now do something they haven't been able to do for years – pass on higher input costs in the form of higher prices. If labor, consumers, and companies all increase their expectations for higher and persistent inflation, this "de-anchoring" of expectations can become self-fulfilling.

[3]Source: Rosenberg Research, "Breakfast with Dave," January 12, 2022.

#4. Interest Rates & The Fed: How will the Fed respond to the threat of inflation while navigating Pandemic-Induced Fog (PIF)?

The Fed, as often is the case, is walking a tightrope. They need to maintain their inflation-fighting credibility while supporting their full-employment objectives. PIF and the multitude of factors impacting the global economy have caused more volatility in economic data making it extremely challenging to interpret. We remain concerned about accelerated and/or excessive Fed tightening **if** the underlying economic growth drivers are waning once PIF clears. We are also keenly aware of the risk the Fed may be behind the curve reining in inflation, resulting in both sustained higher levels of inflation (due to the "de-anchoring" referenced previously) and higher interest rates.



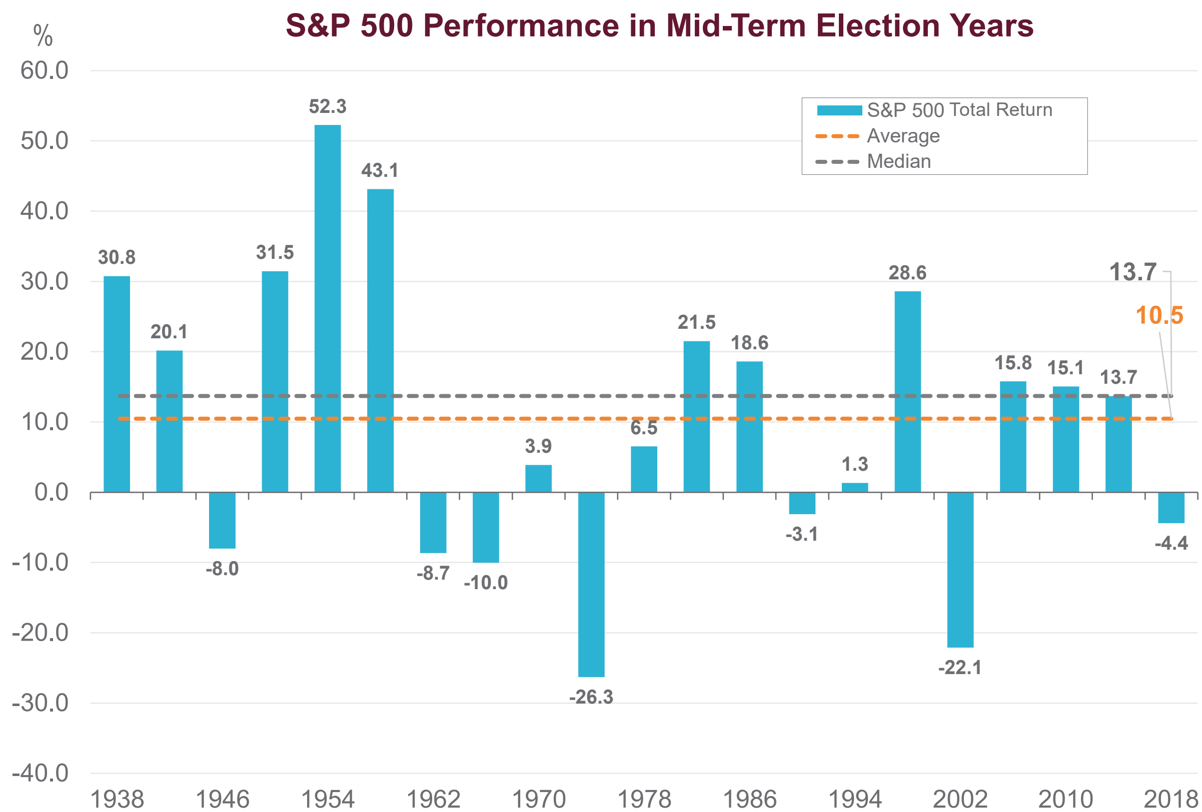
Source: Bloomberg.

#5. Policy and Politics: What major changes can we expect on the regulatory and political fronts here and abroad?

The high level of coordinated US fiscal and monetary stimulus applied in 2020-2021 in response to Covid was unprecedented in recent history, leading to a strong economic rebound. With that said, we may be facing a reversal at least in the US on both fronts, with the Fed set to eliminate their bond purchase program and raise interest rates, while Senators Manchin and Sinema obstruct passage of the now $1.7 trillion Build Back Better Act. Without further support from fiscal spending, US economic growth could slow and markets could sell off, as expectations for more fiscal stimulus are likely reflected in current market prices.

Another consideration is the fact that we are in a mid-term election year—one that could result in an even more divided government leading to inaction. Historically, markets have reacted favorably to a divided legislature.

Finally, regarding China and Russia, we can't speculate whether there will be an escalation in tensions (Taiwan and Ukraine respectively) or an outright conflict. We can say any material action that raises the specter of a military conflict could trigger higher market volatility and a risk-off flight to safety into assets such as US Treasury bonds.



Source: Bloomberg.

#6. Net Zero Emissions: How will efforts by countries and companies to greatly reduce greenhouse gas emissions impact the global economy and markets?

You may wonder how the movement to a net zero economy would make the list in a given calendar year—fair question. Solely looking at the energy transition aspect of this trend, we see accelerating momentum behind capital investments being redirected from the old, fossil fuel-based economy to renewable energy, energy efficient infrastructure and climate resilience. This is a secular trend—one that, we believe, presents a broad range of compelling investment opportunities for all investors, not just those focused on sustainable investing, as countries and companies continue to increase the substantial capital investments in new technologies and infrastructure.

Unfortunately, even efforts driving positive impact can generate negative externalities. While the environmental and social impacts of these investments will take decades to play out, the impact on the real economy is already being felt. Reduced investment in fossil fuel-based infrastructure has been a key factor in the surge in oil and natural gas prices. Future supply shocks (and, thus, elevated prices) are possible until the energy complex has the storage capacity and flexibility to mitigate the effects of renewable energy generation volatility (i.e., think wind farms trying to generate energy when wind speeds are abnormally low for an extended period—something that occurred in Europe last year). Higher energy and other costs affect low-income segments of the population the most. There needs to be a bridging strategy for this energy transition to mitigate those negative effects but that's a topic for another paper.

Potential Outcomes

Given these various catalysts, could 2022 mark a transition from one market regime to another? While prognosticating is a fruitless exercise, mapping possible outcomes can be incredibly valuable at informing portfolio construction and stress-testing to see whether our diversified portfolios contain exposures that can mitigate the risks and capitalize on the opportunities.

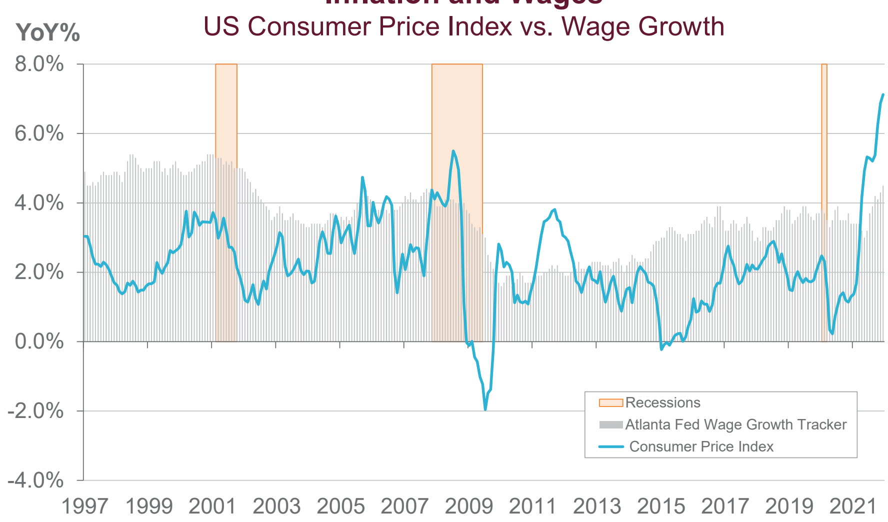
Wide Dispersion: Range of 2022 Wall Street Forecasts for S&P 500

Source: Bloomberg, LNWM.

As we see them, the potential outcomes of the above catalysts are likely to be:

- **Higher market volatility.** Dispersion of opinion, general confusion about economic data, and disorderly transitions (from monetary easing to tightening, fiscal stimulus to reduction, the energy transition, etc.) could lead to policy errors and, as such, a regime in which ***volatility is no longer a visitor but a constant companion***.
- **Inflation tug-of-war.** The convenience of referring to inflation as one metric will be tested as inflationary and deflationary forces within and across economies will continue to engage in a tug-of-war, with some areas experiencing inflationary pressures for longer than others. ***Companies not affected by inflationary pressures or those able to pass on increased costs in the form of higher consumer prices will likely fare better in this environment***, thereby creating a more discernible group of winners and losers (vs. the tide lifting all boats). To complement passive (index) exposure, allocating dollars to actively managed strategies (public, semi-liquid or private) that can capitalize on this dynamic will be of paramount importance.

Inflation and Wages
US Consumer Price Index vs. Wage Growth



Source: Bloomberg, Bureau of Labor Statistics, Federal Reserve.

- **Focus on fundamentals.** Speculation on stock stories -- companies with little or no earnings but purportedly great prospects going public increasingly via SPACs (Special Purpose Acquistion Companies) and day-trading opportunities around meme stocks -- have been two influencers of recent equity market performance. Increased downside and possibly sustained volatility should rattle the new cohort of untrained, novice investors (or should I call them gamblers) who have put stimulus money into online brokerage firms hoping to generate wealth. A shakeout of these speculators and potential questioning of valuations on high-flying stocks could lead to a market environment where seasoned investors drive capital to stocks that seem underpriced relative to their fundamentals and growth prospects. ***Companies with solid balance sheets, cash flow and sustainable earnings growth could be beneficiaries of this potential transition.***
- **Change in growth trajectory.** The prospects for economic growth are highly dependent on if/how the above catalysts and others play out. ***Catalysts could drive an economic slowdown or a broadening of growth opportunities and that will define market leadership.***

Portfolio Positioning

At LNWM we operate in the real world with real clients not in an academic or institutional ivory tower. As much as we, the investment team, enjoy digging deeply into these complex issues, we never lose sight of our overarching purpose—constructing and managing your portfolios to align with your financial and non-financial objectives and calibrated to the risk you can, want and/or need to take. As such, how do our insights related to transitions and catalysts affect portfolio positioning? The chart on the next page presents strategies we are implementing in varying degrees to address the market characteristics that could develop in 2022. *Keep in mind that that what happens for each client portfolio is idiosyncratic and tailored to the client's unique goals, objectives, viewpoints, constraints, biases and general circumstances.*

A word about disciplined asset allocation and risk management: When stock markets rise at the pace we have experienced since the depths of the March 2020 lows, it is easy to forget the importance of exposures that have been inserted in portfolios primarily for their risk management qualities (cash and core fixed income) as well as their diversifying characteristics (hedge funds). We construct portfolios very thoughtfully with each exposure expected to play a distinct role in diversifying the types and level of risk being taken as well as the opportunities they are targeting.

We realize that living with a diversified portfolio is challenging from a behavioral perspective. In any given period, there will be exposures that don't appear to be "working" simply because they are lagging the headline index numbers promoted by the financial media, when in fact they **ARE** working by meeting expectations for the existing market regime. As such, disciplined rebalancing (which may generate capital gains) remains a critical determinant of your risk-return profile and ability to achieve your goals.

Portfolio Strategy	Market Characteristic			
	Higher Volatility	Inflationary Tug-of-War	Focus on Fundamentals	Changing Growth Trajectory
Market weight to global equities given more attractive equity valuations/risk premia outside the US, even though US valuations are not at extremes			X	
Enhanced risk mitigation via core fixed income/cash and alternative asset strategies (e.g. hedge funds*) with low historical correlations to stocks	X			X
Private market investments* (e.g. venture capital, buyouts, real estate, credit, and other distinctive sources of risk and return) with managers actively identifying idiosyncratic opportunities to drive long-term value creation			X	X
Exposure to the long-term trend towards environmental and social sustainability to tap emerging growth opportunities and enhance risk management			X	X
Assets that can generate rising cash flow (e.g., dividend-paying and quality equities, private-debt strategies, infrastructure and real estate) should inflation remain higher for longer		X		

*Available to investors who meet eligibility requirements.

Closing Thoughts

Humans and, by extension markets, are adaptable to change if it's gradual -- more of an evolution than a revolution. As we navigate the waters of the capital markets in 2022, we anticipate making moderate and gradual course corrections, not radical shifts, always focused on our destination: client goal achievement.

Even as investor psychology acknowledges an elevated level of uncertainty, we cannot forget there are likely to be more opportunities developing. As we sort through the confusion brought on by Pandemic-Induced Fog, we feel confident in our approach to risk management, the universe of opportunities resident in portfolios and new ones we are exploring.

Finally, I would like to say how excited we are at Laird Norton Wealth Management to welcome our new teammates from Wetherby Asset Management (WAM). For many years I have respected the quality of WAM's client experience, their investment acumen and their innovative approach to Sustainable/Impact Investing. Bringing our collective and diverse thought processes together will be incredibly accretive for our clients!

ABOUT THE AUTHOR

Ronald G. Albahary, CFA® is Chief Investment Officer at Laird Norton Wealth Management. As the head of LNWM's Investment Strategy and Research Group, Ron determines the firm's investment strategy, directs the investment selection process, and works in tandem with LNWM's client services teams to deliver investment solutions structured to attain each client's unique goals. Prior to joining LNWM, Ron served as CIO or CEO at regional investment firms focused on ultra-high-net-worth families and foundations. Earlier in his career, he held leadership positions in the private client business of major global financial institutions, including Merrill Lynch and Northern Trust Private Bank. Ron has a degree in economics from the Wharton School at the University of Pennsylvania and currently serves as advisor to the Center for High Impact Philanthropy at the University of Pennsylvania.

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Laird Norton Wealth Management ("LNWM") has long partnered with its clients to help them achieve their greatest impact through their investments, legacy planning and philanthropy. As both an RIA and trust company, LNWM provides comprehensive and integrated wealth planning to more than 1,200 individuals, families, business leaders, private foundations and nonprofit organizations.

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INDEX DEFINITIONS

US BONDS: Barclays Capital US Aggregate Bond Index – Covers the US Dollar-denominated, investment-grade, fixed-rate, taxable bond market of SEC-registered securities. The index includes bonds from the Treasury, Government-Related, Corporate, MBS, ABS, and CMBS sectors.

COMMODITIES: Bloomberg Commodity Index - A broadly diversified index of futures contracts intended to be representative of the commodities market. It currently includes 19 commodity futures in seven sectors.

MUNICIPAL BONDS: Barclays Capital Municipal 1-10 Year Index - Tracks the broad market performance of tax-exempt bonds with 1 to 12 years remaining to maturity.

10-YEAR US TREASURY BONDS: BofAML US Treasury Current 10 Year Index – The market value weighted index of public obligations of the US Treasury with maturities of 10 years.

INT'L DEVELOPED EQUITIES: MSCI EAFE Index - A free float-adjusted market-capitalization index that is designed to measure developed market equity performance, excluding the US and Canada. Consists of the following 21 developed market country indices: Australia, Austria, Belgium, Denmark, Finland, France, Germany, Greece, Hong Kong, Ireland, Italy, Japan, the Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland and the United Kingdom.

EMERGING MARKETS EQUITIES: MSCI Emerging Markets Index - A free float-adjusted market-capitalization index that is designed to measure equity market performance in the global emerging markets. Consists of the following 25 emerging market country indices: Argentina, Brazil, Chile, China, Colombia, Czech Republic, Egypt, Hungary, India, Indonesia, Israel, Jordan, Korea, Malaysia, Mexico, Morocco, Pakistan, Peru, Philippines, Poland, Russia, South Africa, Taiwan, Thailand, and Turkey.

US LARGE CAP EQUITIES: Russell 1000 Index - Measures the performance of the large-cap segment of the US equity universe and represents approximately 92% of the US market.

US SMALL CAP EQUITIES: Russell 2000 Index - Measures the performance of the 2,000 smallest companies in the Russell 3000 Index, representative of the US small-capitalization securities market.

LIQUID HEDGE FUNDS: HFRX Global Hedge Fund Index – A daily-valued index designed to be representative of the overall liquid hedge fund universe. It is comprised of all eligible hedge fund strategies; including but not limited to convertible arbitrage, distressed securities, equity hedge, equity market neutral, event driven, macro, merger arbitrage, and relative value arbitrage. The strategies are asset weighted based on the distribution of assets in the hedge fund industry.

ILLIQUID HEDGE FUNDS: HFRI Fund Weighted Composite Index – A global, monthly-valued, equal-weighted index of over 2,000 single-manager funds that is designed to be representative of the overall composition of the hedge fund universe. It is comprised of all eligible hedge fund strategies. Constituent funds report monthly net of all fees performance in US dollar and have a minimum of $50 Million under management or a twelve (12) month track record of active performance. The HFRI Fund Weighted Composite Index does not include Funds of Hedge Funds.

GLOBAL REITS: FTSE EPRA/NAREIT Developed Real Estate Index - A measure that tracks the performance of listed real estate companies and REITs worldwide.

DIVERSIFIED PORTFOLIO: 10% US Municipal Bonds; 10% US Core Bonds; 25% US Large Cap Equities; 5% US Small-Cap Equities; 22% Int'l Developed Equities; 9% Emerging Markets Equities; 4% Global Infrastructure; 13% Illuquid Hedge Funds; 2% Commodities.

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