Outlook for December 2021

Key Market Drivers

Fourth quarter economic data in the U.S. shows an economy that appears to have more than fully recovered from the disappointing summer lull caused by a combination of supply induced inflation and the spread of the delta variant of Covid-19. High savings rates and accelerating growth in jobs and wages are driving consumer spending on both goods and services. Businesses continue to ramp up production in attempt to better match inventories to this strong demand. Some highly publicized supply chain issues are beginning to dissipate as port congestion declines and product availability improves in areas such as semiconductor chips for autos.

However, as we enter December the recently discovered Omicron variant of Covid-19 is generating concern about another virus wave causing renewed lockdowns, travel restrictions, and consumer hesitancy to spend on services. It is too early to adequately assess the virulence of this new strain or its potential resistance to vaccines. Several European and Asian countries, however, are beginning to impose restrictions, particularly on the unvaccinated. Wider adoption of such restrictions could restrain global growth at the end of the quarter moving into next year.

Inflation appears to be in the process of peaking on the loosening of some supply logjams although the rate of price increases will remain stubbornly high for a few more months. This will be particularly true in the services sectors where labor slack is fading, and wages need to rise to attract employees. Any hesitancy of production workers going into the factories due to the new variant could blunt the burgeoning supply chain improvements.

Chinese authorities tend to be more draconian in their reaction to Covid waves by implementing zero tolerance policies. But they are also more geographically focused on imposing lockdowns and extreme mobility restrictions only in those regions showing positive test results. Overall demand appears to be slowing in China as we approach the winter months.

Our Perspective

Equity Markets	› The strong year to date performance in the broader equity markets masks the disparity seen this year between the higher growth sectors such as technology and consumer discretionary and the more cyclical sectors such as industrials and materials which tend to suffer more in this Covid-19 era. With the average stock still trading at reasonable valuation multiples, earnings growth still comfortably positive, and interest rates rising only gradually over the next year, equity markets are poised to advance in 2022, but not nearly to the same extent experienced this year.

Outlook for December 2021

Our Perspective	
Equity Markets *Continued*	› More aggressive government responses to the impending Omicron wave may further pressure the relative performance of developed international equities, although any signs that a stricter response may not be necessary can help propel these markets higher as they arguably benefit more from thawing supply chains. › Emerging markets equities are clearly in the crosshairs of any new virus wave due to greater exposure to cyclical sectors and generally lower vaccination rates among the population. Low valuations are helpful in cushioning any blow, but the catalyst for outperformance must be a continuation of the broader global economic expansion and lessening severity of subsequent virus variants.
Bond Markets	› The possible acceleration in tapering bond purchases and the uncertain impact of the Omicron variant have combined to flatten the yield curve amidst rising concern of a monetary policy mistake where the Fed tightens too quickly into an economy that is already slowing. With the impact of the next virus wave largely uncertain, we expect intermediate term interest rates to drift higher moving into next year on continued above average economic growth. › Despite some recent spread widening due to concerns about a pickup in default rates should a new virus wave prove more severe than anticipated, high yield debt is still rather expensive historically and likely does not adequately compensate investors for the greater credit risk. › Another wave of Covid-19 first discovered in South Africa has put disproportionate pressure on emerging markets as vaccination rates in these economies remain relatively low. A stronger dollar has further impacted emerging market debt. The asset class appears cheap within the broader fixed income realm, but its near term performance will be very dependent on the Omicron variant of Covid-19 having a smaller economic impact than previous waves.
Monetary Policies & Currencies	› Federal Reserve Chair Jerome Powell, along with other Fed governors, are openly speculating on the need to possibly accelerate the bond purchase tapering program so they can use Fed funds rate increases to battle inflation. An adjustment to the program, which may be announced in this month's FOMC meeting, would likely lead to an end of first quarter completion which could pave the way for the first rate increase this summer. Of course, much would depend on the persistency of the inflation rate within the broader economy.

Outlook for December 2021

Our Perspective	
Monetary Policies & Currencies *Continued*	› The bar for tightening monetary policies seems to be higher for the other developed market central banks in Europe and Asia as inflation rates are not quite as high nor is economic growth as strong as in the U.S. The Bank of England is generally more hawkish and may be the first to tighten somewhat early next year, but the European Central Bank and the Bank of Japan are unlikely to raise rates at all in 2022. › The Peoples Bank of China is in a trickier spot as demand is slowing, but officials are concerned more about asset price bubbles as opposed to goods price inflation and will attempt to confront these through more pointed policies impacting specific industries. › As the Fed will likely be the first major central bank to tighten policy, the dollar continues to climb against a trade weighted basket of foreign currencies. This currency strength can be a further sign of peak inflation as commodity prices and import prices tend to be negatively correlated to directional dollar moves.
Commodities	› The multilateral announcement of a coordinated release of oil from strategic reserves ignited the beginning of a decline in oil prices last month which was exacerbated by discovery of the new Covid-19 variant. With energy prices now off roughly 20% from their highs, this market sector is more fairly valued given potential supply from U.S. shale producers and the likelihood OPEC scales back their planned production increases. › Gold will likely struggle to hold current levels as inflation wanes and the Fed is closer to normalizing monetary policy. Cryptocurrencies are currently acting as a risk asset as opposed to a market hedge as longer-term strategic investors still need to participate in these markets to offset the dominance of speculators.

What This Means for Investors

The emergence of the new Omicron variant is a stark reminder that we are investing in an environment where the world must learn to adapt to and better live with the long-term reality of Covid-19. Vaccines and the possibility that each subsequent strain is less virulent than its predecessor may mute the inherent market volatility and allow investors to refocus on continued economic growth and growing evidence that supply of both goods and labor is beginning to catch up to demand.

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