Outlook 2022: Let the Sun Shine In

In last year's outlook, we suggested that the storm of 2020, would bring calm in 2021. As we look back on the year, perhaps a more fitting analogy would have been that 2020 was merely the *lightning* in the storm, and that 2021 was the boom of *thunder*, which, though not as harmful, still took everyone by surprise. In this edition of our Thinking Man Series, we reflect on lessons learned from 2021, as well as provide our outlook for 2022 – what we hope will finally be the year of calm and clearing we have all been waiting for.

In 2021, world economies began to normalize, as highly effective vaccines gave individuals the confidence to resume their lives. However, with the rise and spread of the delta and omicron variants, world governments have also had to find the sweet spot between normalization and effective containment. Thankfully, the overall momentum has proven to be positive, with the U.S. avoiding new lockdowns – given that new variants, though more transmissible, have also proven to be less fatal, particularly for the double and triple vaccinated.

Furthermore, 2021 was a year where markets seemed to move at a frenzied pace, digesting and acting on economic and financial news and data with a vigor unlike anything we have ever seen. We often joke that when our own grandmothers are asking about markets, supply chains and cryptocurrencies, then something must surely be up.

The reality, however, is that it really was an eventful year. We would say that the most important themes – and likely the most important themes going forward – are all in some way policy related. There was the ongoing political gamesmanship surrounding the bi-partisan infrastructure and reconciliation bills, the debt ceiling debate, China's "pen-stroke" policy initiatives, and the various monetary policy controversies, specifically, who would ultimately lead the Fed, and what exactly was the right thing for the Fed to do. In our view, some of these continue to be the main themes to watch out for in 2022, as markets will continue to look to Washington for guidance on where we are headed. As we move away from the early phases of the cyclical recovery and into normalized monetary policy, we expect market returns to moderate and volatility to increase.

The Thinking Man's Approach

December 2021 | Series #91
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- 2022 will be a transitional year where the withdrawal of monetary and fiscal supports will lead to heightened volatility
- Supply chain disruptions are likely to persist into the first half of the year, but should clear up by year-end – however, wage inflation will potentially be stickier
- Focus on quality companies with strong margins, high cash flow yields, and pricing power, particularly in cyclical industries
- There will likely be another "lost year" in fixed income – investors should focus on generating income with private alternatives & real estate and/or by selling volatility (i.e. covered-calls)
- Manager selection and operational value-creation will be particularly important in private asset classes, as returns are set to moderate
- Primary risks will be social and geopolitical, though inflation, coronavirus variants, and the midterm elections are also near-term concerns

For more on how we are positioning our portfolios, please contact your investment advisor or ideas@bigsurpartners.com

I. Macroeconomic Landscape

Monetary Policy

Perhaps the most dominant theme of 2021 was the ongoing inflation debate between *Team Transitory* and *Team Sticky*. The former has as its biggest champion, the Federal Reserve, who for most of 2021, left its ultra-loose monetary policy unchanged – i.e. keeping the fed-funds rate near zero, and buying $120bn in U.S. government debt and mortgage-backed securities (MBS) a month.

Though most of the year's PCE / CPI prints suggested that inflation was running hot, the Federal Reserve was comfortable to stay its course because 1) its new policy framework targets average inflation over longer periods of time, 2) employment remained above its frictional level, and 3) politically, Chairman Powell's re-nomination hinged on not becoming a hawk right as the country was beginning to emerge from a crisis. In our view, it is no coincidence that the Fed's December announcement that it would double the pace of its tapering from $15bn / month to $30bn / month, came *after* Powell's re-nomination as Fed Chairman. Since then, the Fed's dot plot, which provides an overview of FOMC member expectations for the trajectory of the fed-funds rate, has shifted from 1-2 rate hikes, to 3-4 rate hikes in 2022, implying a new sense of urgency for reining-in inflation.

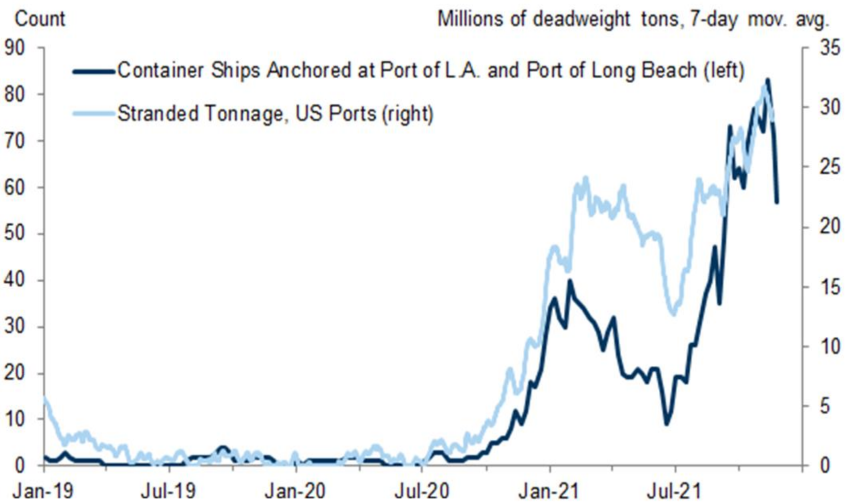
BSP View: 2022 will represent a transitional phase in monetary policy, where the Federal Reserve will conclude its asset purchases and begin raising rates. However, our outlook for monetary policy rests on a somewhat cynical interpretation of the Fed's relationship with the federal government. For some years now, the Fed has ceased to be a truly independent organization. Its official mandates may be to steer inflation and employment, but unofficially, it will also always do what it takes to protect markets and the federal government's balance sheet. We call this the Fed's *shadow mandate*.

With U.S. debt and deficit levels fast approaching the $30tn and $3tn marks, we also believe that the Fed cannot afford to let rates rise *too much*, without the dollar cost of servicing that debt growing to an economically crippling level. It is in the interest of the TRED (i.e. Treasury / Fed) to keep a lid on rates, because the economic damage of having to service our debt at higher rates would likely be much higher than the economic damage from consumers seeing their purchasing power eroded. The Fed will let rates creep up, but only to a point. Exactly what that point is, remains the question of the decade.

Supply Chains

The Fed has argued that inflation will be transitory (a term it has since abandoned), because supply chain disruptions will ultimately also be transitory. And indeed, some of the most affected areas of the supply chain have shown signs of easing, as stay-at-home demand for durable goods (i.e. autos, housing, furnishings, and appliances, as opposed to services) has partially normalized. Having said that, the supply side continues to be a mixed picture, given the divergence in coronavirus mitigation efforts across continents (especially in Asia Pacific), and the truly *international* nature of the U.S. supply chain.

On one hand, the trucking industry has mostly replenished its shortage of drivers to pre-Covid levels (+100,000 truck drivers added in 2021), while the massive backlog of container ships at the twin ports of L.A./Long Beach has also shown signs of easing (down to 50-60 ships from a peak of 80-90 ships). On the other hand, the stranded tonnage at U.S. ports, supplier delivery times, and production material leadtimes (according to ISM) are all still at, or near, all-time highs. The Freightos Baltic Index, which tracks the cost of shipping 40 ft. containers on 12 global trade-lanes, has receded 15% from its all-time peak reached in September, but is still ~5.0x its March 2020 level.



Source: Goldman Sachs Equity Research

BSP View: supply chain pressures will almost completely normalize by the second half of 2022, as continued global re-openings should transition consumer demand to more services. As inventories continue to be replenished and stranded port tonnage continues to clear, we would expect core PCE inflation to settle around 2.5-2.75% by year-end 2022.

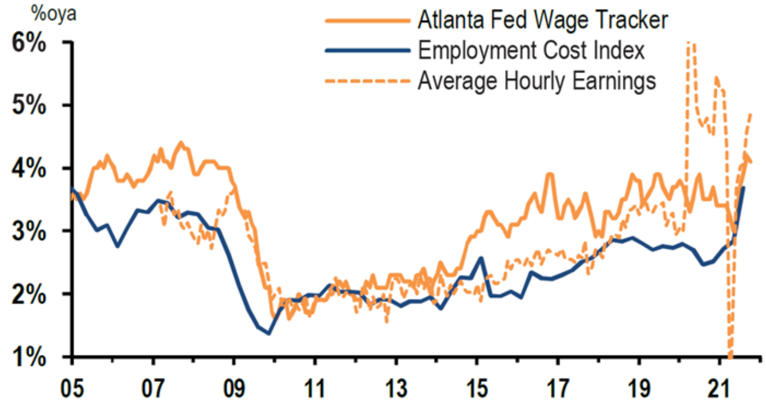
The Money Supply & Employment

The counterargument to our inflation base case is *Team Sticky's* position that there are structural forces at play that will see inflation persistently run higher than target. These are: 1) the unprecedented expansion of the money supply and 2) the changing nature of employment in America.

Though traditional economic dogma states that printing more money should make that money less valuable, we would also offer a reminder that in a world of fiat currencies, what any given Central Bank does, should not be taken as right or wrong in the absolute, but rather in the context of what the other Central Bank's in the world are doing. To that end, we would only highlight that the world's major Central Banks have all pursued highly expansionary policies – perhaps only with the exception of the People's Bank of China which is only now beginning to loosen. Additionally, US Treasury yields continue to offer a premium to much of the world's developed market sovereign credit, which in many cases continue to provide negative *nominal* rates (not to mention the effective real rates). In short, the debasement of the U.S. dollar continues to be a tail-end risk for us, at least in the near-to-medium term.

The point on employment is much more interesting to us because it represents psychological and cultural shifts that are sometimes entirely missed when tracking econometric data. Over the last several months, we have seen the job opening rate at a persistently high level, while the unemployment rate at 4.2%, is only 0.7%-pts above its pre-pandemic level of 3.5%. This disconnect is of course explained by the labor force participation rate, which at 61.8%, is 1.5%-pts below it's pre-pandemic level. Whether because of early-retirement, unemployment benefits, self-employment, or wealth effects many people are simply choosing to not return to work. The result has been a marked uptick in wage inflation. Both the Atlanta Fed Wage Tracker, and the Bureau of Labor Statistic's Average Hourly Earnings growth are trending around 4-5%.

Figure 20: Alternative measures of nominal wage growth



Source: BEA, BLS, Atlanta Fed, J.P. Morgan

BSP View: wage increases are not likely to sustain themselves for much longer, and will likely prove to be transitory going into the back half of 2022. Data from Indeed Hiring Lab, suggests that care responsibilities, Covid concerns, and unemployment benefits continue to account for more than 60% of the reasons cited by people who are not returning to work. As Covid fades, or at a minimum becomes endemic, we would expect more people to return to the labor force, relieving a significant portion of the upwards pressure on wages. Even if we were to buy the narrative that everyone *currently* out of the labor force is in fact, *permanently* out of the labor force, we still think it is more likely that labor abstention will only hasten the transition to labor automation / A.I. / robotics, rather than to a sustained period of wage inflation.

Economic Growth

Despite fading stimulus and continued supply-demand imbalances, we maintain a positive outlook for growth. World economic output for 2022 is forecasted to grow at ~4.0%, and US GDP is expected to also grow at a real rate of 4.0%, according to the Federal Reserve's latest economic projections and Street estimates. This projection is lower than the 5.5% real growth in 2021, but still comfortably above trend.

We should note that the majority of these economic projections were released prior to the start of the omicron wave, and have since been revised downwards. Based on what we know of omicron fatality and responsiveness to vaccines to date, we see only a modest reduction to 2022 growth forecasts, likely on the order of 10-20bps.

BSP View: at the end of the day, what will determine the long-term wellbeing of the American economy is the degree to which it can continue to be an engine of technological innovation and economic productivity. To that end, the pandemic has only accelerated technological productivity gains. In our view the American economy, though faced with plenty of socioeconomic and political dysfunction (i.e. wealth/ racial inequality and political gridlock), continues to be at the forefront of the technologies of the future: whether it be A.I. / quantum computing, the renewable energy revolution, medical research, or aerospace & defense. As Warren Buffet once famously said, "Never bet against America."

Fiscal Policy

According to J.P. Morgan's macro research team, fiscal easing alone added more than 3%-pts to GDP growth last year. Broad-based policy supports were a crucial catalyst for jumpstarting the global recovery. As we move through 2022, governments will continue to unwind their support – nonetheless, we believe that policy stances remain supportive for growth.

In mid-November, President Biden signed the highly anticipated $1 *trillion Infrastructure Investment and Jobs Act* into law, which will improve U.S. roads, bridges, and water systems, and includes funding for projects in public transportation and broadband. The biggest challenge for the Biden Administration will be the Build Back Better Plan (BBB), which, after months of negotiations, is essentially dead in the water (at least in its current form). Though failure to pass the bill likely represents a fiscal drag for 2022, overall it is likely to be a positive for corporate profits, as any new tax increases will now be pushed out. Though we still believe that an amended (and likely smaller version of the bill) will still be passed in the first half of 2022, we see the bill's failure as a net near-term positive for markets.

II. Asset Allocation and Asset Class Views 2022

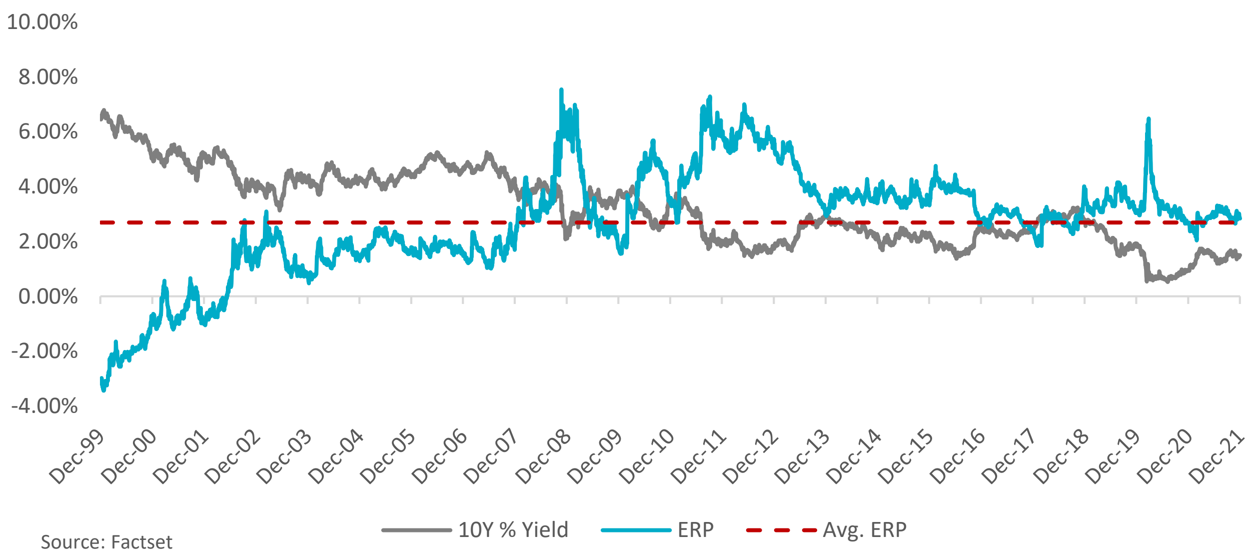
Equities

As we discussed in *Series 90: Profits, the Mother's Milk of Stocks,* equity prices in 2021 have been supported by earnings growth above and beyond simple base effects. At the time of this writing, the S&P 500 has returned 27.6% YTD, while the Dow Jones Industrial Average (DJIA) and the Nasdaq have returned 17.5% and 23.1%, respectively. In that same period, next-twelve-month (NTM) earnings estimates have been consistently revised upwards which has translated to an essentially flat forward earnings multiple. The S&P 500 currently sits at 23.1x NTM earnings (0.4x higher than year-end 2020), while the DJIA and the Nasdaq sit at 18.7x and 36.6x NTM earnings (1.8x lower and 2.4x higher than year-end 2020, respectively). The main conclusion is that, though markets have appreciated, they are not necessarily more *expensive*, given the impressive rate of growth in corporate sales and earnings over the last year.

Additionally, given the aforementioned employment frictions and inflationary pressures, companies have been forced to do more with less. This, combined with an ability to pass-on cost increases to the end-consumer has translated into more than *200bps of operating margin expansion* in 2021 alone. In our view, it is entirely justifiable for the market to credit higher-margin businesses with higher multiples.

BSP View: as we transition from the early-cycle recovery phase to the mid-cycle phase we would expect earnings multiples to stabilize, or even decline slightly by year-end 2022. We also expect to see high single-digit earnings growth in 2022, though profitability growth will ultimately depend on the trajectory of inflation. Over the course of 2022, we expect to see a more volatile environment, in-line with a non-QE world and heightened geopolitical and/or social risks.

We continue to believe that the most important metric for gauging upside / downside risk in equities is the equity risk premium, calculated as the spread between the market's earning's yield (i.e. the inverse of the 1 year-forward PE multiple) and the 10Y Treasury yield. Yes, multiples across the board are at historically elevated levels, but then again so is the price of 10Y Treasury note, which translates to a low yield, and therefore an equity risk premium that is hovering right around its long-term average. In short, investors are still getting paid a premium for assuming the risk of holding equities, and barring a blowout in yields during the coming tightening cycle, we would expect that to continue to be the case going into 2022.



Source: Factset

Though December was a tough month for equities due to the rise of the omicron variant and the Federal Reserve's hawkish policy tilt, all three indices are still at, or near their all-time highs. As we saw over the course of 2021, the market has been content to buy-in to any dips, and the now ubiquitous lemma: TINA, or "There is No Alternative" is as true today as it was at the beginning of the year. In a world of low rates, and high inflation, being risk-on is the only way to generate a positive real return. With heightened volatility, we would expect many over-extended companies to re-rate (we've already seen some of that happen beneath the surface). For these reasons, in 2022 we will continue to favor high quality, cash-flow producing companies.

Below we offer five themes for navigating the lower returns and heightened volatility that we expect for 2022:

1. Quality and cash flow are king
2. Value / Cyclicals over Growth
3. Favor stocks with pricing power and/or a low % labor cost
4. De-risk with income (i.e. dividend stocks or buy-writes/covered calls)
5. The index is <u>not</u> the market – underweight FANG's

Quality and cash flow are king

As we discussed in *Series 89: The Best & Worst of Times,* history has always proved that whenever financial reality becomes totally out of whack with, for lack of a better term, *real* reality, that it is the financial reality which has to ultimately adjust. Much like 2020, 2021 was a year of financial market excesses. Meme stocks, SPACs, and certain pockets of cryptocurrencies continued to attract a great deal of attention, while investors continued to put money behind high-growth, but ultimately unproven and/or unprofitable business models.

We believe that the tide of euphoric expectations is likely to turn in 2022; and that only companies with strong management teams, highly differentiated products, high and growing margins and high cash flow yields will outperform. In 2022, market participants will be forced to step back, and seeing all of the money they have made chasing speculative growth, ask themselves… *now what?* We believe the answer will be: *put it in quality, put it in names that are making money today.*

Value / Cyclicals over Defensives / Growth

As we head into 2022, we also continue to favor value-cyclical sectors which include materials, diversified financials, banks, energy, and companies levered to a resurgence in industrial manufacturing like autos and industrial components.

Though sectors like Energy, Financials, and Materials have been among the best performing YTD, we believe that they are likely to continue to outperform. With respect to energy (+50% YTD) we continue to see a sustained period of elevated oil prices, given that capacity investments have failed to keep up with the forthcoming resurgence in travel and services demand. Much like oil producers were slow to turn off the taps when demand cratered in April 2020, we believe they will also be slow to turn on the taps when demand roars back.

With respect to financials, materials, and industrials, we continue to believe that the reopening and rising rate environment is not fully priced in, as market multiples are essentially flat, and the sectors appear cheap on an absolute basis. Financials are currently trading at 17.5x forward earnings, Materials at 22.1x, and Industrials at 22.3x. This is relative to Info Tech, Consumer Discretionary, and Communication Services which currently trade at 31.8x, 56.7x, and 25.2x forward earnings, respectively.

Favor stocks with pricing power and / or a low % labor cost

We believe that a key source of differentiation in corporate performance over the next year will be how sensitive a company's business model and cost structure are to inflationary pressures. For most businesses, these inflationary pressures can take the form of either raw material and/or transportation cost increases (i.e. cost of goods sold), or they can take the form of increased labor expense as result of having to pay higher wages / salaries to attract people back into the labor force.

Our view is that raw material / transportation cost increases are likely to subside by mid-year 2022, but that wage/salary inflation may be marginally more persistent in the near-term. In turn, companies will have to either charge higher prices, or accept lower margins. To that end, businesses with low labor components should have an easier time in preserving or even expanding their margins.

The problem is that it is precisely high margin businesses like SaaS and Banks that tend to have a larger labor component in their cost structures. Considering this, we would summarize our framework as: *avoid companies with high share of labor costs in their cost structures (measured as revenue/# of employees or market cap/# of employees), unless they already have top-notch margins to begin with.*

De-risk with income (i.e. dividend stocks or buy-writes/covered calls)

Another way of naturally de-risking our equity investments (without having to take money off the table) is to position portfolios to produce income, either by purchasing high dividend paying stocks that generally have lower betas, or by harvesting elevated levels of volatility by selling covered calls on a meaningful portion of a portfolio's equity exposures.

With respect to the latter, we would just remind the reader the importance of gauging an options implied volatility relative to its historical volatility, as well as to the broader market's volatility. For example: there is no use in selling SPY calls when the VIX is at 15, only to find yourself having to buy them back when VIX is at 30, or worse, not buying them back and giving up the underlying's gains because you got called away. For this reason, we think it's important to use covered calls opportunistically: selling calls when volatility is high, and opportunistically buying them back when volatility is low. Fortunately, our view is that volatility is likely to stay high through most of 2022, which should make a strategy that sells 1-3 month at the money (ATM) calls on a rolling basis fairly successful overall (as it was for most of 2021).

The index is not the market– underweight FANG's

One of the most important developments in markets in 2021 was the heightened concentration of index weightings on only a handful of corporate behemoths. Pretty much in every sector, the largest three companies represent more than a third of market capitalization. In Communications, Consumer Discretionary, Energy and Technology, the largest three companies by market cap represent between 50%-70% of the total sector. Overall, the 10 largest companies in the S&P 500 (i.e. 2% of the names) represent 31.3% of the index's capitalization. The result is that when we see markets move on any given day we are not necessarily getting the full picture.

For these reasons, we will be underweight FANG's (which we use as a general acronym for the largest, growth-style technology companies: Apple, Microsoft, Alphabet, Amazon, Tesla, Facebook, and Nvidia). To be sure, these are also some of the highest quality, most profitable companies in the world, and we don't necessarily think they should all just be lumped together as part of the same class. We do, however, believe that weighting these names proportionally to the index in a portfolio, would cause an investor to miss opportunities for similar quality growth, at a more reasonable price further down in the small-to-midcap space.

Fixed Income

As we discussed in *Series 81: The End of the 60/40 Portfolio* traditional fixed income markets continue to offer a false sense of security. To be sure, there is a very real sense of security which is the structural seniority that accompanies most forms of credit. In sovereign credit, this is derived from a government's ability to either print more money, or tax its citizens in order to fulfill its financial obligations. In corporate credit this sense of security comes from capital structure seniority; from being first, or near-first in line to recover your money if a company's financial health deteriorates.

Equally important to the attractiveness of fixed income is the ongoing income component and the lack of, or even inverse correlation with many other asset classes. In short, investors hold fixed income assets because 1) they are more senior and therefore safer from a capital preservation standpoint, 2) they generate an ongoing stream of income; and 3) they provide "portfolio ballast" with which to weather financial storms (i.e. un-correlation).

Literally, all three of these virtues have all but collapsed: 1) capital preservation is not guaranteed in a world of rising rates (i.e. we are at the end of a multi-decade bull market in rates); 2) the ongoing stream of income is actually *negative* on a real basis; and 3) historical correlations have broken down in the face of widespread central bank intervention in fixed income markets.

With this in mind, we believe there are two main investing themes for fixed income securities during 2021:

1. Underweight sovereign credit / government bonds
2. Reach for yield with fixed-income alternatives or longer duration, not more credit risk

Underweight sovereign credit

There are only really two possible outcomes for government fixed income securities in 2022: either rates will go up in which case investors will lose some of their principal, or rates will not go up in which case a significant chunk of portfolios will return negative real rates. In either case investors stand to lose.

Our view is that the latter is much more likely than the former, especially in developed markets. Though there are likely some opportunities in emerging market sovereign credit we also believe there are far better alternatives for reaching for yield, than taking incremental sovereign credit risk.

Reach for yield with fixed-income alternatives or longer duration, not more credit risk

Spreads in both investment grade and high-yield corporate credit are flat to down YTD, and well below their historical averages, which to us signals, only the potential for further downside in fixed income markets. If investors do have to put some money into fixed income we would suggest doing so in Hybrids & Perpetuals, which in some cases, *do offer positive real yields*, and also happen to be in sectors which we like in general going into 2022, like Banks.

Additionally, we continue to favor private debt, which offers significant illiquidity premiums for equally high quality companies typically at floating rates, and often with equity kickers which provide additional upside in subsequent rounds of funding.

Alternatives

At BigSur, our investment objective is to achieve efficient beta from public markets and meaningful alpha from private markets. In an environment of elevated valuations, unprecedented levels of dry powder, record deal activity, and low interest rates, manager selection is more important than ever.

The alternative investment landscape has experienced exponential growth over the last several years resulting in intense competition for deal flow. With the death of the 60/40 portfolio, investors have flocked to alternatives as a source of less correlated returns for achieving portfolio diversification, as well as to yielding assets in a scarce yield environment. Technology platforms and solutions have also been introduced into the marketplace, making alternative investments more accessible to mainstream investors.

While we expect alternative investments to outperform public market indices on a go-forward basis, we believe that there will be significant return compression across sub-asset classes, and a greater divergence in manager performance. Over the last few years, "a rising tide lifts all boats" has benefitted private market participants. We believe this will no longer be true, as heightened valuations in a rising rate and inflationary environment leave little room for error. There is a significant amount of capital chasing a limited number of quality assets, and as such, we seek to continue identifying and partnering with managers that can control their destiny – highly specialized, "hands-on" managers that serve as true partners and value creators for their portfolio companies, beyond just serving as passive capital providers.

Private Equity

US Private Equity (PE) has experienced its fastest pace of deal and exit activity in at least two decades. Cheap and abundant debt has propelled PE deal making, while PE-backed exits have boomed on the back of one of the hottest IPO markets since the early 2000s. Over the past year, PE funds have posted their best (albeit mostly still unrealized) returns on record. Private equity returns at record levels threaten future returns as high valuations make the decision to sell much easier than the decision to buy.

With investment timelines shortening and valuations rising, prudent private equity managers must take on a targeted sourcing approach by building strong conviction in those investment themes that will continue to generate sustainable growth, regardless of broader economic performance. That is easier said than done, as these processes require years-long preparation, in-depth market research, large investments in human capital & deal sourcing capabilities, and extensive relationship building with target companies. Few firms have the resources and bandwidth to execute upon these secular and "recession-resistant" strategies, but they are key for winning off-market deals, maintaining entry multiples at reasonable levels, and creating value throughout the investment's holding period. BigSur clients have partnered with numerous specialized and highly focused managers in the middle market and large buyout spaces, as well as increased exposure to secondaries strategies to further diversify vintages and combat high valuations with discounted entry points.

Beyond rising valuations, there are plenty of other challenges in store for managers as they navigate unchartered waters. The health of portfolio companies is sensitive to supply chain constraints, delivery delays, inflationary pressures, and the prospect of higher interest rates – all of which are present today. The performance of public markets is also an important factor for private equity activity, as a strong market paves the way for exits via IPO or, dare we say, SPAC mergers, as well as increased M&A activity for strategics with strong balance sheets (partially driven by higher equity prices).

As we discussed in *Series 88: Manager Selection in a Frothy PE Environment*, a fundamental question in private equity has always been how dependent returns are on leverage, and whether investment returns represent appropriate compensation for the level of risk taken. We seek to partner with managers that "control what they can control" – in this case, managers that derive the majority of value creation from operational improvements instead of financial engineering.

Increasingly, we are gaining a deeper understanding of portfolio company leverage levels in our due diligence process, as most debt undertaken by companies is floating rate – meaning a higher cost of servicing debt is on the horizon. We believe that many heavily indebted companies with dubious business models have been held afloat thanks to government stimulus. As that stimulus dries up and debt servicing costs increase, we expect to see increased level of restructurings or outright liquidations. To once again quote Warren Buffet, "Only when the tide goes out do you discover who's been swimming naked."

Venture capital (VC), which we will treat as part of private equity for purposes of this outlook, had a record year in 2021, with total capital invested by fund managers reaching $476 billion exits soaring to $410 billion. While VC currently represents one of our smallest asset allocation buckets, it is a growing one as clients demand access to innovation and next-generation technologies. Our approach to accessing VC has been to "de-risk" investments through diversified fund-of-funds vehicles that invest in blue chip managers. This allows us to access venture without exposing clients to an asset class with notoriously high return dispersion. We have also been committing capital to secondary funds in the space, and a few specialized early-stage managers that focus on building instead of betting on companies.

Our biggest concern in venture lies in the later stage, pre-IPO companies given heightened valuations (high multiples on revenue vs. earnings) and buoyant investor demand (those looking to make a quick profit), which are all factors that are heavily dependent on a continued robust equity market. Across all stages of venture, there has been a significant appreciation in valuations. Seed investments are now pricing where Series A investments used to, and Series A investments are now pricing where Series B investments used to, and so on. While we believe that technology companies will continue being the driving force of markets, our view is that valuations are extended and that a lot of caution is warranted for investing in the asset class. Looking into 2022 and beyond, we will remain highly disciplined and vigilant as we allocate to new venture opportunities.

Private Debt

Debt markets have run hot as cheap lending costs have led to new issuance of risky debt. With interest rates near rock bottom, investor demand for income-producing assets has risen tremendously. In our opinion, the outlook for private credit remains favorable as the floating rate nature of the asset class positions it well for a potentially rising rate environment. Additionally, private debt yields continue to offer ~250-300bps of illiquidity premium to equivalent public-market securities.

Company valuations have also been rising faster than the percentage of debt contribution, causing private equity cash contributions to reach 50-60% of transaction values (compared to 2019 levels of 40-50%). These historically high levels of equity supporting the debt in today's deals remain a significant bright spot in the market, providing an additional cushion of protection.

In the private debt space, we have always strived to partner with managers that have both private credit and private equity expertise, given that in a downside scenario they have the in-house capabilities to overtake and reposition an asset. Most of our private debt exposure has been in direct lending funds (mainly secured by real estate and other real assets) and mezzanine debt to middle market companies. Both strategies have benefitted from market tailwinds, with real estate prices roaring back to above pre-COVID levels (specifically multifamily and industrial assets) and mezzanine strategies outperforming their target returns, given that equity kickers have generated further upside with increased valuations and portfolio exit activity.

We have come across many managers in our diligence process that are offering companies lower rates and covenant-light protections to win opportunities and deploy capital. The managers that BigSur invests with are mindful of these practices, stating that their pace of deployment has significantly slowed as good opportunities have become scarce. The managers we work with have been moving up in terms of company size and quality, sacrificing absolute returns slightly but improving risk-adjusted returns, which we believe is the right approach amidst the market's exuberance. With cheap debt and heightened PE exit activity, many companies are also refinancing and paying off loans quicker than anticipated, resulting in higher IRR figures but lower return multiples for the asset class.

More recently, we have focused on sourcing investments higher up in the capital structure, allocating capital to broadly diversified funds that solely hold senior secured, floating rate securities.

Real Estate

Inflation fears have attracted investors to Real Estate, as rent increases generally follow the pace of broader price increases in an economy. In an inflationary environment, increases in the cost of land, construction, and labor are likely to make new supply less financially feasible, further benefitting existing property owners. Additionally, private real estate offers low correlation to stocks and a negative correlation to bonds, which is beneficial for achieving diversification.

Historically, wide spreads have existed between real estate cap rates and interest rates, which means that real estate can be acquired with yields that generate more than the cost of debt, resulting in attractive cash-on-cash returns. Over the last several years, we have moved away from acquiring individual commercial real estate assets to committing capital to diversified real estate private equity funds, as the compression in cap rates has driven the need for specialization and scale to win the most competitive deals. We have exited most of our direct real estate investment holdings and redeployed capital into value-add/opportunistic fund vehicles that are highly diversified, institutionally managed, and offer equity-like returns.

More recently, we have been shifting to higher quality assets by focusing on stabilized real estate funds that generate healthy levels of income. In a negative real rate environment like we find ourselves in today, private real estate investment trusts (private REITs) are offering a ~5% annualized yield (distributed monthly), with further potential upside from price appreciation.

Even if rates rise, our view is that spreads are wide enough for real estate to remain attractive. These are funds whose primary underlying holdings include multifamily and industrial assets, which are the property types that have been the largest beneficiaries from COVID-19 as behavioral shifts toward working from home part-time and shopping online become more permanent. These portfolios also have a limited exposure to commercial office buildings and no exposure to retail, which are the hardest hit sub-sectors in real estate. Lastly, these vehicles generally offer significant tax benefits for investors, flexible liquidity provisions, and much lower volatility than their public market counterparts.

Asset Allocation

We conclude this section with our current recommended BigSur Partners Moderate Tactical Allocation. As usual, the asset allocation represents our suggested model portfolio that incorporates our views and themes discussed previously in the article. Starting this year, we are also comparing our suggested portfolio with the average family office asset allocation, published in the UBS Global Family Office report, which can be seen in Table 1.

Table 1

	2021	
Asset Class/Type	**BigSur Partners**	**UBS GFO Report***
Cash	3%	10%
Fixed Income	28%	18%
Developed Markets	20%	13%
Emerging Markets	8%	5%
Equity	36%	32%
Developed Markets	29%	24%
Emerging Markets	7%	8%
Alternatives	28%	37%
Private Equity/Debt	17%	18%
Real Estate	9%	13%
Hedge Funds	2%	6%
Real Assets	5%	3%
Gold & Commodities	4%	2%
Intangibles / Collectibles / Cryptocurrencies	1%	1%

*Source: UBS Global Family Office Report 2021

For comparison and statistical purposes, 121 family offices were surveyed for the report. The average total net worth of those who reported was $1.6 billion. From the total family offices surveyed, 46%

support only one generation, 48% support two generations and 5% support three generations. 69% were founded after 2000, 26%, were founded after 1950, and 5% before then. Finally, the surveyed family offices are spread across 35 markets, with two-thirds based in EMEA (including Switzerland), with the remaining one-third located in Hong Kong, Singapore, the U.S. and Latin America.

3. Potential Risks

For 2022, we have identified four risks that have the potential of derailing or delaying the global economic recovery, or of providing new sources of uncertainty that could spook markets in the short term:

1. The resurgence of more lethal coronavirus variants
2. Stickier than expected inflation (i.e. a monetary policy error)
3. The escalation of geopolitical conflicts with China or Russia
4. 2022 midterm elections

The resurgence of more lethal coronavirus variants

Thus far, the data suggests that each new coronavirus variant, though generally more transmissible, is also less lethal. According to a CDC report published on December 20th, Omicron is now the most dominant variant in the US, accounting for 73% of reported cases and spreading faster than any prior variant. Early studies demonstrate that Omicron infections result in milder illness than previous variants, yet officials are warning that the new variant could swiftly overtax the healthcare system.

Daily coronavirus counts are currently higher than at the peak of the recent Delta wave and are expected to surge this winter amidst the holiday season. This poses a significant risk for markets, as hospitals are already nearing maximum capacity, and while not a politically nor economically favorable action to take, the reintroduction of lockdowns may be the only solution for slowing down the spread. Additionally, we do not entirely discount the possibility of other more lethal or more transmissible variants arising in 2022.

Stickier than expected inflation (i.e. a monetary policy error)

The combination of record low rates and the highest inflation readings in nearly 40 years is feeding the demand for leverage and exposure to risk assets, thus increasing valuations and market risk. Many investors fear that central banks have kept monetary policy too loose for too long as they have taken a "wait and see" approach towards inflation.

Over the last few months, efforts to write off inflation as transitory have encountered a reality check. The Fed faces an increasing probability of having to slam on the monetary policy brakes in 2022, as tracking too far behind the curve could result in rate hikes being quicker and larger than currently anticipated. Such a monetary policy error such could present a shock to an already nervous market.

The escalation of geopolitical conflicts with China or Russia

A divided and distracted America consumed by internal political fighting has invited adversaries such as China and Russia to become more dominant players on the global stage. Chinese President Xi Jinping is paving the way for himself to begin an unprecedented and potentially lifelong third term as China's leader and is continuing controversial efforts to consolidate Hong Kong and Taiwan under Chinese rule. China is also aggressively expanding its military personnel and nuclear arsenal, so much so that strategists believe it could have twice as many warheads in the coming years as previously projected.

With respect to Russia, Vladimir Putin has been amassing thousands of troops and deploying them to the Ukrainian border, increasing the threat and likelihood of a looming invasion, and using Russia's energy supply as leverage for controlling influence over neighboring European countries. Any escalation on these fronts may force the US to intervene, raising concerns of years-long geopolitical conflicts should these events materialize.

The 2022 midterm elections

Republicans are well positioned to take back some control of Congress heading into the new year, as taming inflation, fixing supply chains, and getting people back to work are amongst the biggest concerns voters have today. President Biden's approval ratings have also been in steep decline, and internal divisions amongst moderate and progressive Democrats have become highly publicized, most recently with the failure to pass the much-anticipated Build Back Better package.

Should Republicans take back the House and/or Senate, it could signal the end of the Biden administration's domestic agenda. Overall, most analysts believe a return to conservative economic principles and tighter spending controls could be a longer-term positive for markets. Having said that, many of Biden's policies could be rolled back with a Republican win, presenting short-term risks to sectors and industries that have benefitted from ambitious infrastructure, social, and climate-related spending initiatives.

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