OCTAVIA
WEALTH ADVISORS

2022 Outlook: Navigating Moderation

February 2022

Building a Lifelong Partnership

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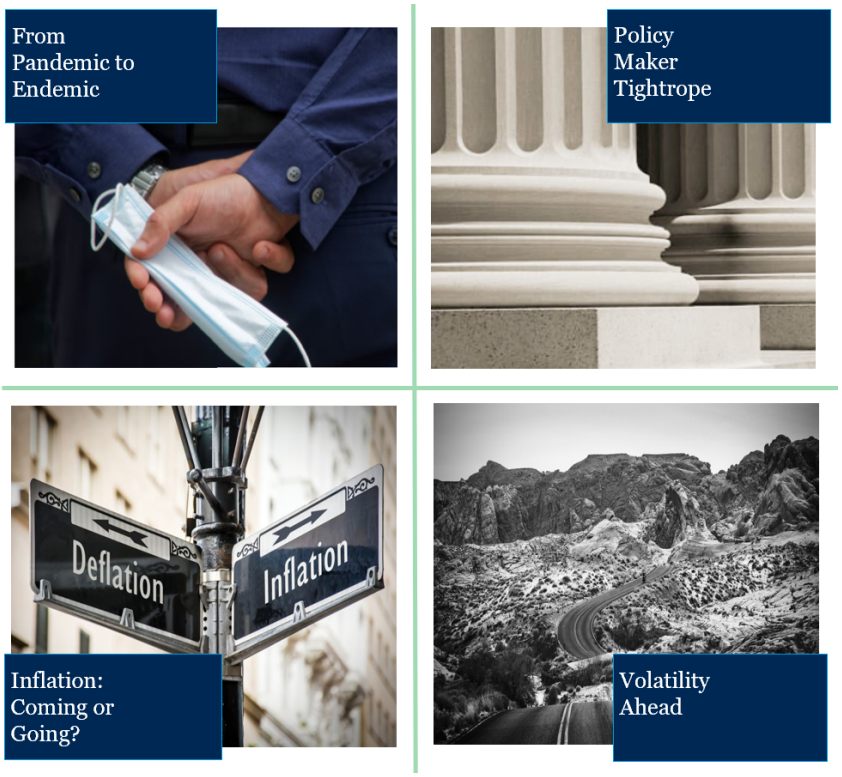
Following another year of strong market returns, our view of 2022 sees opportunity, but with far greater moderation. Our 10-year forward-looking market assumptions, provided by our strategic partners at Fiducient, remain well below long-term averages, with muted returns expected across asset classes.

2022 Themes

In our view, navigating moderation takes preparation, a mental shift, and thoughtful risk management. Diverging global monetary policies, shifting winds in inflation, and normalizing earnings expectations require consideration. With these potential headwinds in mind, we warn against market timing or narrow "bets" on certain asset classes. In today's environment, where uncertainty is higher and dispersion of outcomes wider, we believe a thoughtful long-term approach remains the best recipe for success. In our view, the following topics will help provide a framework for how to approach markets in 2022.



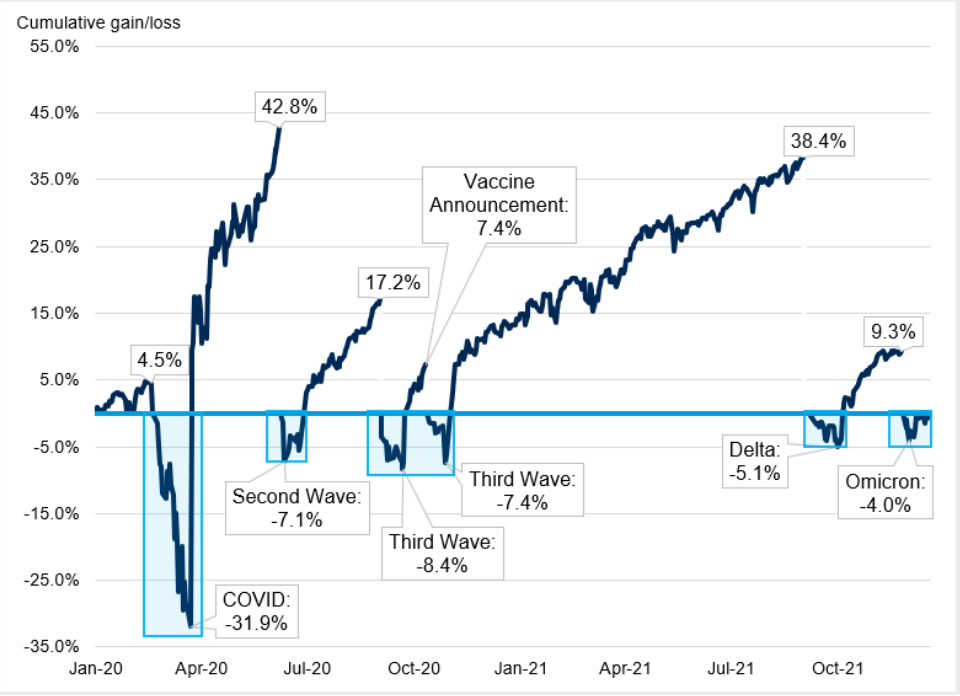
From Pandemic to Endemic

The 1918 Great Influenza wreaked havoc around the world and upended the lives of millions of people. Over 100 years later, variations and mutations of that distant virus are still present in the modern flu.

The hopes for full eradicating COVID-19 have faded as the virus seems likely to linger as a secular virus, not a transitory one. This shift in mentality has many implications for investors. Market volatility around future unknown variants should be expected, and the disparity between winners and losers in such bouts may be wider than it has been in the past.

It should also be noted that as COVID has moved from an "unknown unknown" to a "known unknown" with various scientific discoveries, the severity of drawdowns with each new COVID wave or variant has reduced. Nonetheless, the headline risk is likely to remain.

S&P 500 PERFORMANCE FOLLOWING COVID-RELATED EVENTS



Source: FactSet, as of December 20, 2021. Returns represented by S&P 500 Index. Investors cannot invest directly in an index. Index performance is reported gross of fees and expenses and assumes reinvestment of dividends. Past performance does not indicate future performance and there is possibility of a loss.

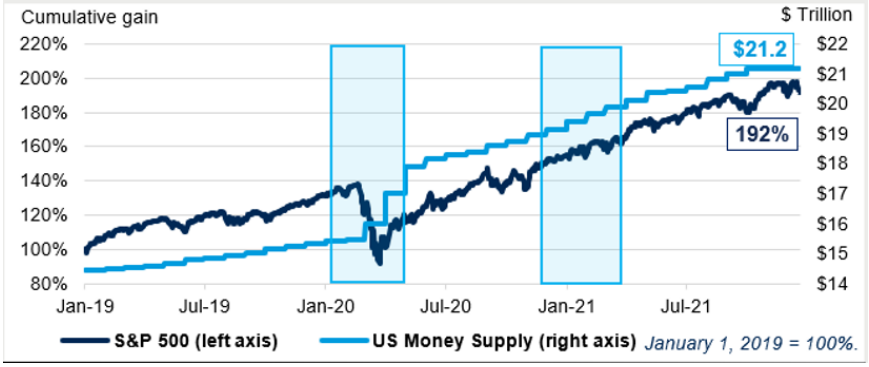
IMPACT ON YOUR PORTFOLIO

Headline risk is here to stay as new variants emerge and global policy shifts in response. Thoughtfully assessing risk posture can help prepare for the unknown and avoid costly emotional decisions during bouts of volatility. Additionally, there tends to be a disparity between winners and losers in volatile environments—think of "stay-at-home" stocks skyrocketing in the spring of 2020 while others struggled. Diversification can help prevent too much exposure to potential "losers." Finally, more active rebalancing may be warranted. It is unlikely that COVID-induced volatility will fit into any schedule. Plan ahead to be prepared.

Policy Maker Tightrope

The U.S. Federal Reserve acknowledged the persistence of inflation, with the majority of FOMC members now expecting to raise the Federal Funds rate three times in 2022[1]. Around the world, 38 central banks raised rates at least once in 2021 to fight rising inflation[2]. However, the era of global coordination is beginning to fade as policy makers evaluate growth in their own markets. Recently, the European Central Bank said it is unlikely to raise rates in 2022[3], while the People's Bank of China reversed course and cut rates in response to slowing growth and market volatility. These crosscurrents provide both opportunities and challenges for investors ahead.

ASSET INFLATION AND THE FED



Source: FactSet, as of December 20, 2021. Money Supply represented by U.S. M2. Investors cannot invest directly in an index. Index performance is reported gross of fees and expenses and assumes reinvestment of dividends. Past performance does not indicate future performance and there is a possibility of loss.

The Federal Reserve grew the money supply by 50% since 2019, with monetary expansion moving in lockstep with equity gains.

The Fed will have to balance fighting inflation while not disturbing markets.

IMPACT ON YOUR PORTFOLIO

Diverging inflation dynamics and monetary policies between countries can have implications across all asset classes. We believe this environment is attractive for active fixed income management that can manage interest rate risk in a challenging macro-environment.

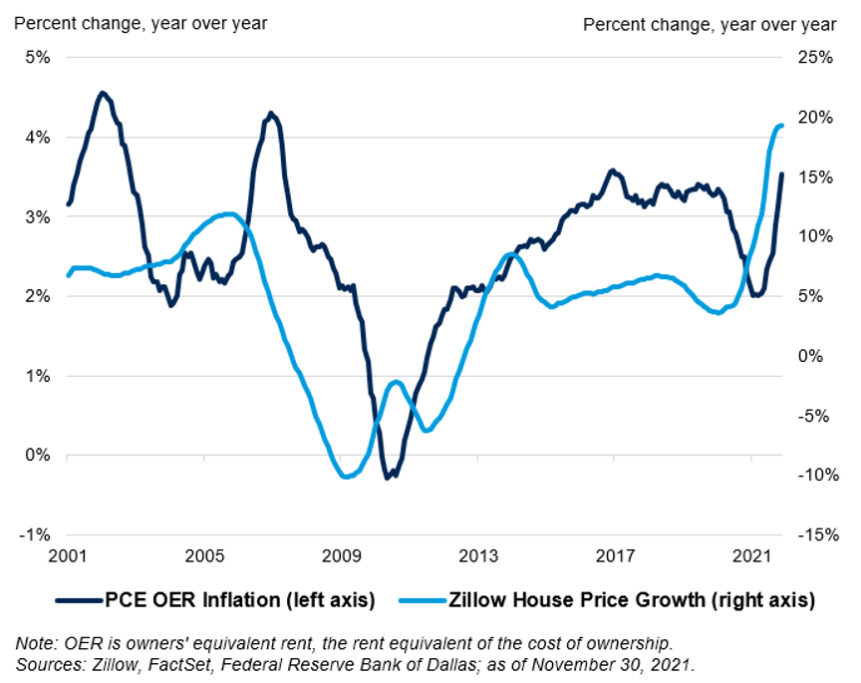
Within equities, we believe maintaining exposure to Emerging Markets is warranted, particularly amidst Chinese market volatility. The recent market pullback and stimulus measures from the People's Bank of China may indicate increasing regulatory oversight, providing support for markets and potential opportunities.

[1] CNBC, "The Majority of Fed members forecast three interest rate hikes in 2022 to fight inflation," December 15, 2021, https://www.cnbc.com/2021/12/15/the-majority-of-fed-members-forecast-three-interest-rate-hikes-in-2022-to-fight-inflation.html
[2] BIS, Central Bank Policy Rates, https://bis.org/statistics/cbpol.htm
[3] MSN, "European Central Bank Cuts Pandemic Bond Buying, but Pledges Further Stimulus," https://www.msn.com/en-us/money/markets/european-central-bank-leaves-interest-rates-unchanged-cuts-bond-buying-further/ar-AARSmLP?ocid=uxbndlbing

Inflation: Coming or Going?

The Consumer Price Index rose 7.0% year-over-year as of December 2021—the largest increase since 1982[4]. Inflation was initially attributed to a demand surge as shelter in place orders eased. Demand remains high with consumer net worth near all-time highs[5] and wages rising[6], but producer factors have played in as well. Supply chain disruptions and rising energy prices also support an environment for above average inflation compared to recent history.

MORE INFLATION TO COME FROM HOUSING?



Note: OER is owners' equivalent rent, the rent equivalent of the cost of ownership.
Sources: Zillow, FactSet, Federal Reserve Bank of Dallas; as of November 30, 2021.

Owners' Equivalent Rent (OER) is a measure of home ownership cost. It tends to follow, but lag, home prices on the market.

OER makes up 30% of the CPI and is the single largest component of the inflation benchmark. Should this relationship hold, upward pressure on inflation could persist as long as the housing market remains hot.

TRANSITORY OR PERSISTENT? YES!

Transitory Inflationary Factors	Persistent Inflationary Factors
Energy Prices	Wage Increases
Transportation (Auto Prices)	Rents/Housing
Supply Chain Disruptions	
Semiconductor Shortages	

IMPACT ON YOUR PORTFOLIO

Inflation can and does take many forms. In 2021, inflation was led by rising energy prices, supply chain issues, and shortages. Inflation in 2022 and beyond is likely to see these factors subside, but they may be

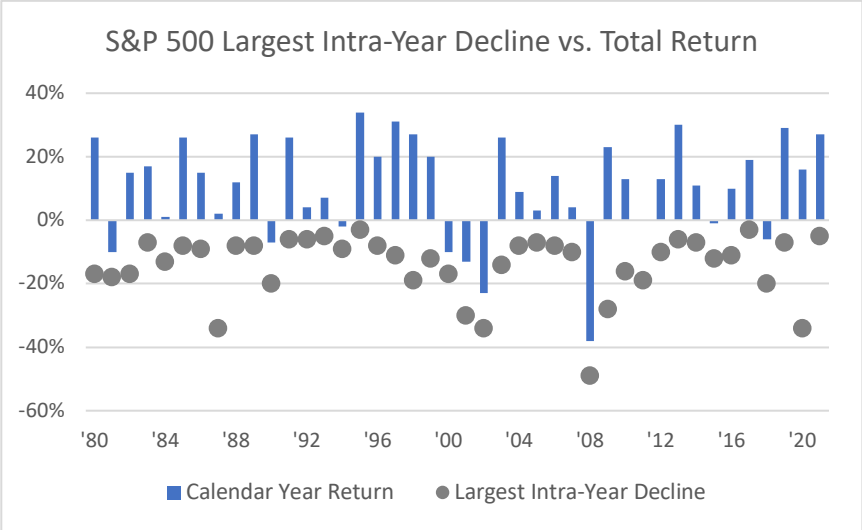
[4] Federal Reserve Bank of St. Louis, "Consumer Price Index for All Urban Consumers," https://fred.stlouisfed.org/series/CPIAUCSL
[5] Federal Reserve Bank of St. Louis, "Household Net Worth," https://fred.stlouisfed.org/series/BOGZ1FL192090005Q
[6] Federal Reserve Bank of St. Louis, "Household Net Worth," https://fred.stlouisfed.org/series/CES0500000003

supplanted by persistent rising wages and housing costs. We believe broadening exposure to real assets can help guard against shifting tides and sources of inflation and may help maintain long-term purchasing power of portfolios while diversifying away from equity risks.

Volatility Ahead: Be Comfortable with Your Risk Posture

Domestic equities reached 71 new all-time highs in 2021[7], supported by accommodative monetary policy, a 43% earnings increase year-over-year[8], and investors fleeing from negative real yields in fixed income as inflation ramped up.

However, the steady ascent of equity markets masked the churn beneath the surface. 92% of S&P 500 companies experienced a drawdown of at least 10% in 2021[9] and the "style war" between value and growth stocks raged as investors weighed economic reopening with emerging COVID variants. As we look to 2022, conditions do not appear as favorable for a smooth ride upward.



Volatility does not always mean lower markets. Since 1983, the average intra-year drawdown was 9.3%, but the average calendar year return was 13.5%.

IMPACT ON YOUR PORTFOLIO

Increasing allocations to U.S. equities, diversifying away from concentrated interest rate risks, and distributing across real assets can help guard against the potential for higher volatility in its many manifestations.

However, we continue to remind investors that timing markets rarely proves to be a successful investment strategy. Rather, understanding your ability to bear risk and thoughtfully managing exposures can lead to more persistent success over time.

[7] FactSet, as of December 31, 2021.
[8] Refinitiv, "S&P 500 Earnings Dashboard 21Q3," https://lipperalpha.refinitiv.com/2021/12/sp-500-earnings-dashboard-3/#
[9] "Schwab 2022 Market Outlook: Ebb Tide", Schwab Center for Financial Research

Final Thoughts for 2022

Diverging global monetary policies, changing winds in inflation, and market reactions to the ever-changing pandemic are likely to impact all asset classes. However, navigating a shifting landscape and potential volatility is not a new task for investors. While 2022 may bring challenges, we believe that investors can position themselves for success by managing fixed income risks, fine tuning equity allocations, broadening exposure to inflation related assets, and taking a strong mental approach to COVID curveballs.

And of course, your Octavia wealth advisor and support team will be here to help you every step of the way.