CUNA MUTUAL GROUP

2022 Economic & Financial Market Outlook

Post-Pandemic Adjustment Period

Scott D. Knapp, CFA
Chief Market Strategist

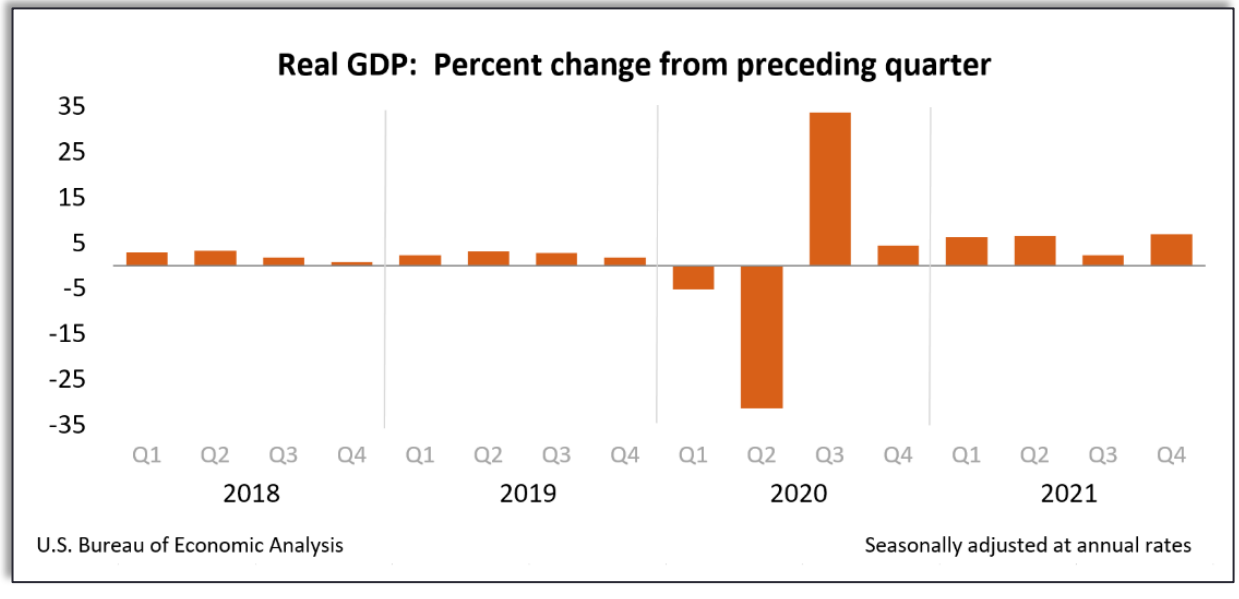
2022 Letter to Investors

"The global economy spent all of 2021 in a highly distorted state. Indeed, the on-again, off-again recovery from the pandemic created conditions that had little or no precedent. Coexistence of many data points made little sense when evaluated relative to standard economic theory and previous business cycles."

Post-Pandemic Adjustment Period

Cyclical Change

Almost Every Data Point is Highly Distorted



Base effects and rescaling amplify distortions.

Adv. 4Q 2021: 7.0% 2021: 5.7%

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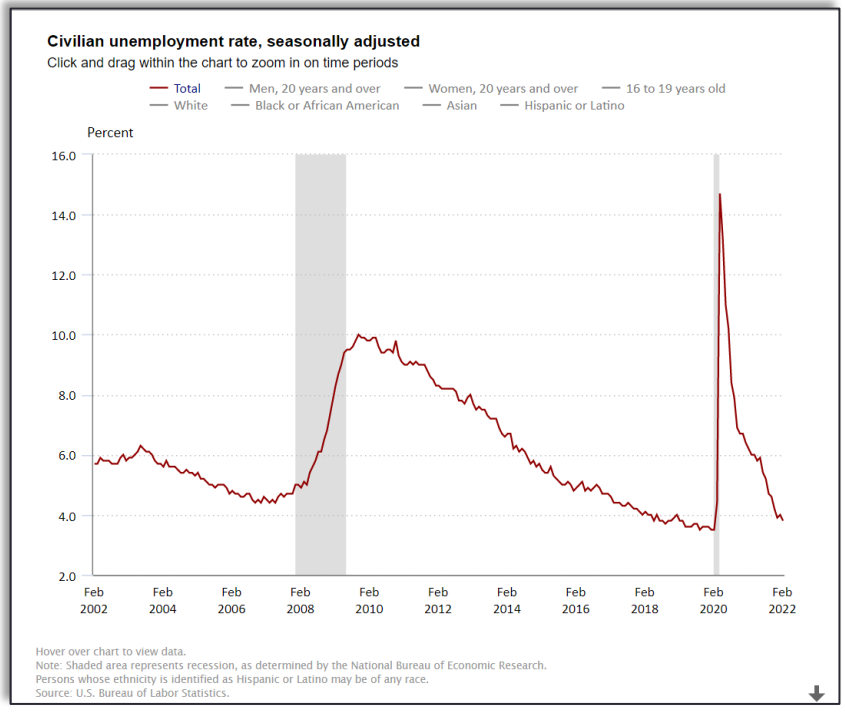

From collapse to full employment at breakneck speed.

Asset Class Returns as of December 31, 2021

Name	Asset Class	QTD	1 Year	3 Year	5 Year
S&P 500 TR USD	US Large Cap	11.03	28.71	26.06	18.48
Russell Mid Cap TR USD	US Mid-Cap	6.44	22.58	23.28	15.10
Russell 2000 TR USD	US Small Cap	2.14	14.82	20.02	12.02
MSCI EAFE NR USD	International Stock	2.69	11.26	13.54	9.55
MSCI EM NR USD	EM Stock	-1.31	-2.54	10.94	9.88
Bloomberg US Agg Bond TR USD	Investment Grade Bond	0.01	-1.54	4.79	3.57
Bloomberg US Corporate High Yield TR USD	High Yield Bond	0.71	5.28	8.83	6.30
DJ US Select REIT TR USD	US Real Estate	17.22	45.91	16.84	9.65

Some of the best conditions ever for financial markets last year:

Record high corporate profits and record negative real interest rates.

Source: Morningstar Direct

Asset Class Returns as of March 8, 2022

Name	Asset Class	YTD
S&P 500 TR USD	US Large Cap	-12.26
Russell 1000 Growth TR USD	US Large Cap Growth	-18.58
Russell 1000 Value TR USD	US Large Cap Value	-6.32
Russell Mid Cap TR USD	US Mid-Cap	-12.82
Russell 2000 TR USD	US Small Cap	-12.42
MSCI EAFE NR USD	International Stock	-15.11
MSCI EM NR USD	EM Stock	-10.92
Bloomberg US Agg Bond TR USD	Investment Grade Bond	-4.04

Changing inflation and interest rate expectations are leaving a mark.

Russian invasion of Ukraine adds uncertainty.

Source: Morningstar Direct

The Thief Returns:

An exploration of rising inflation rates.

Big Change: Average Inflation Targeting

Excerpt from the Federal Open Market Committee's amended version of "Statement on Longer Run Goals and Monetary Policy Strategy":

> *…the Committee seeks to achieve inflation that averages 2 percent over time, and therefore judges that, following periods when inflation has been running persistently below 2 percent, appropriate monetary policy will likely aim to achieve inflation moderately above 2 percent for some time. [emphasis added]*

Source: U.S. Federal Reserve FOMC, August 2020

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Translation: We're going to let the economy run hot for a while to increase employment and narrow income disparity. Don't worry. We're confident we can engineer a "soft landing."

Source: U.S. Federal Reserve FOMC, August 2020

Not What the Fed Was Hoping For

CNBC BREAKING NEWS

Inflation rises 7% over the past year to the highest level since 1982

Mostly already priced in with expectations for rate hikes this year.

-4.2% real wage growth.

Sources: CNBC and U.S. Bureau of Labor Statistics on January 12, 2022

Possible Sources of Recent Inflation

1. Post-pandemic monetary stimulus
   - Fed balance sheet expansion, including purchases of ETFs and high-yield bonds
2. Post-pandemic fiscal stimulus
   - Direct payments to consumers and businesses to replace lost GDP
3. Supply chain disruptions
   - Tight labor market and COVID-induced shutdowns of the global transportation system

- Translation: Demand up, supply down, you do the math.

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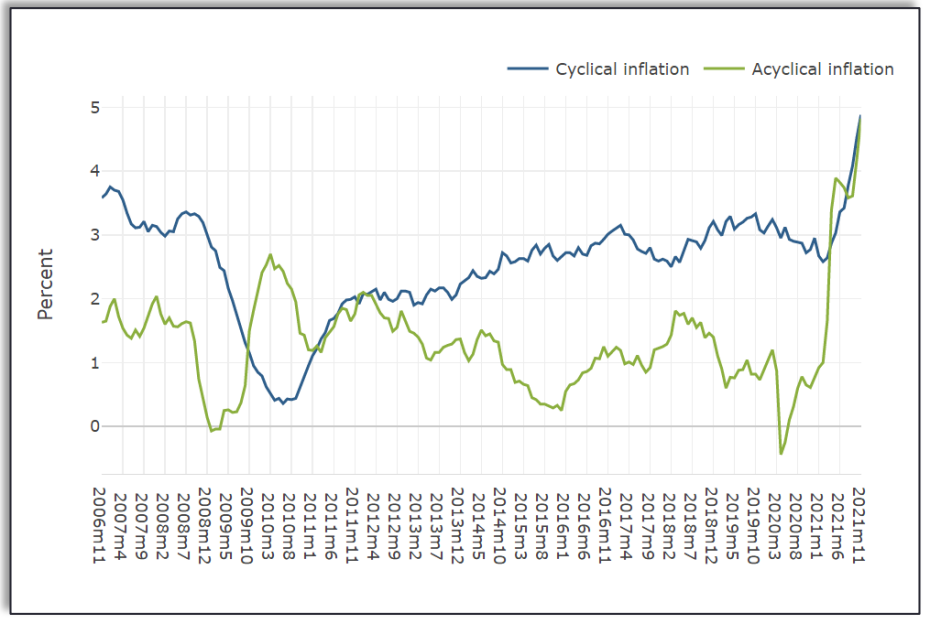
Is inflation "transitory" or entrenched?

Data-Dependence Leads to Change

Cyclical and Acyclical Core PCE Inflation (year-over-year)



Stickier inflation caught up with less-sticky inflation.

The “transitory” thesis became less plausible as time passed

Source: San Francisco Federal Reserve Bank

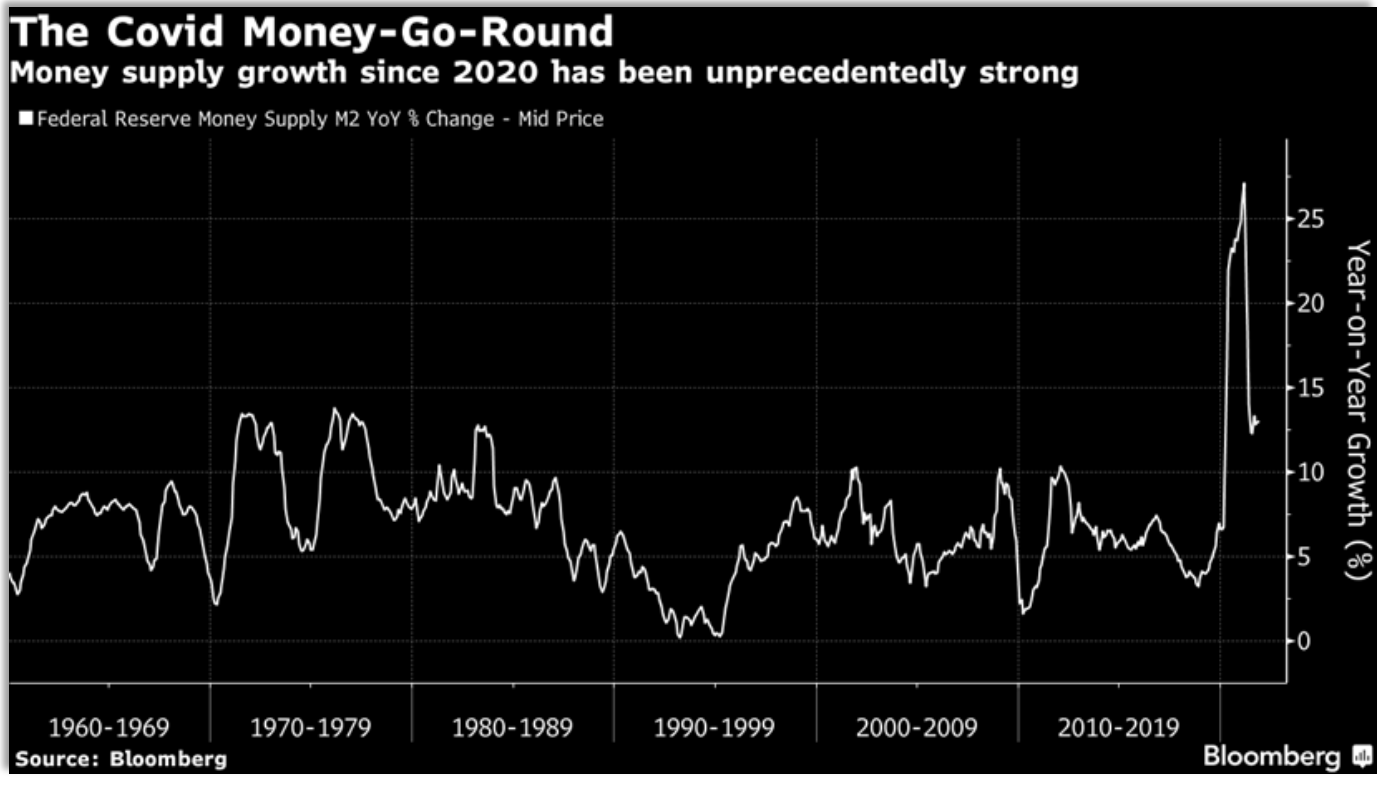
Data Dependence Leads to a Change in Perspective

"We tend to use [the word 'transitory'] to mean that it won't leave a permanent mark in the form of higher inflation," Fed Chairman Jerome Powell told Congress on Tuesday. "I think it's probably a good time to retire that word and try to explain more clearly what we mean."

Jerome Powell

Source: Bloomberg News

M2 Exploded. Now Coming Down.



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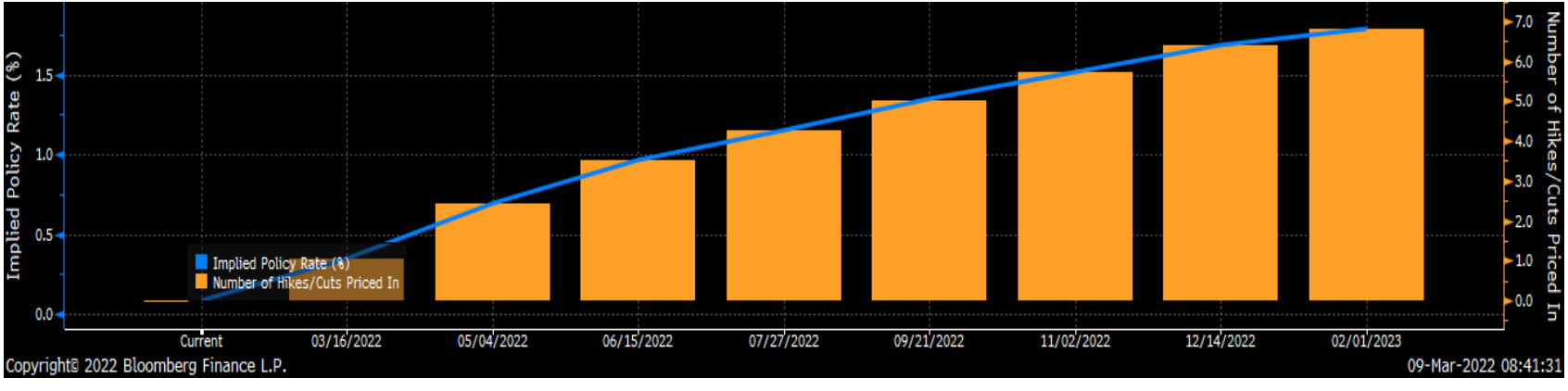
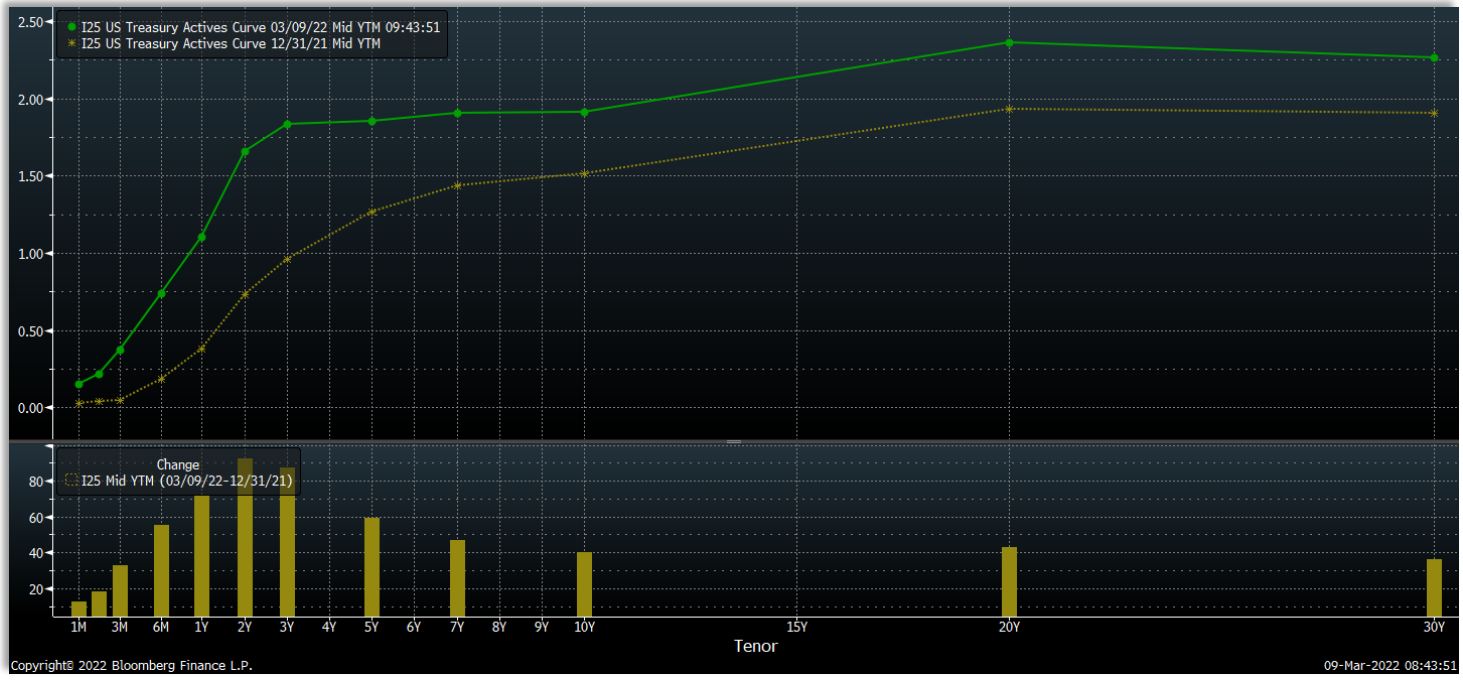


Over six hikes in the fed funds target rate expected by EOY.

Fed Tools: 1) Messaging, 2) Tapering, 3) BS Reduction, and 4) Rate Hikes

Source: Bloomberg

Priced In



Expectations for inflation and Fed hikes are already priced in interest rate markets.

Key question: Will it be enough?

Economic and Financial Market Outlook:

Will the expected policy response be enough?

Economic and Financial Market Outlook

Scenario 1: "Return of Transitory" Probability: Moderate

- Hot inflation rates progressively cool and provide vindication for the Fed
  - Markets currently provide support for this scenario: UST yields and TIPS breakeven rates
- The Fed shrinks its balance sheet at a steady rate
- Hikes the fed funds target about four times during the year
- Fiscal impulse subsides
- This modest pace of normalization is minimally disruptive to markets
- Inflation rates slow organically and in response to tighter monetary and fiscal conditions

Economic and Financial Market Outlook

Scenario 2: "Classic Fed Mistake" Probability: Moderate

- Inflation rates run hotter than markets currently expect
- The Fed falls behind the curve and responds with an aggressive tightening program
  - Unexpected interest rate hikes and shrinkage of its balance sheet
- Tighter monetary conditions cause a pronounced decline in economic growth
- Momentum in the economy and financial markets is lost and inflation rates ultimately fall from lofty levels
  - The good news is the inflation problem gets fixed
  - The bad news is the fix comes with a recession next year
- Market multiples fall in response to tighter monetary conditions
- Markets fall in response to a slowing economy

Which will it be?

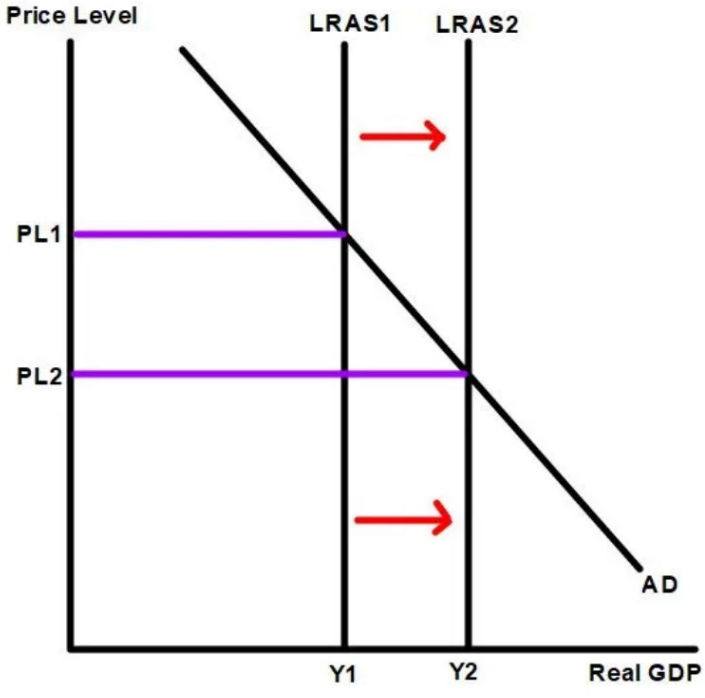
Scenario 1?
Scenario 2?
or
A scenario not listed?

"If you have a coin in your pocket that can be flipped, you are on equal footing with us in your ability to pick correctly. Support for both scenarios is strong, but little data tilt probabilities either direction."

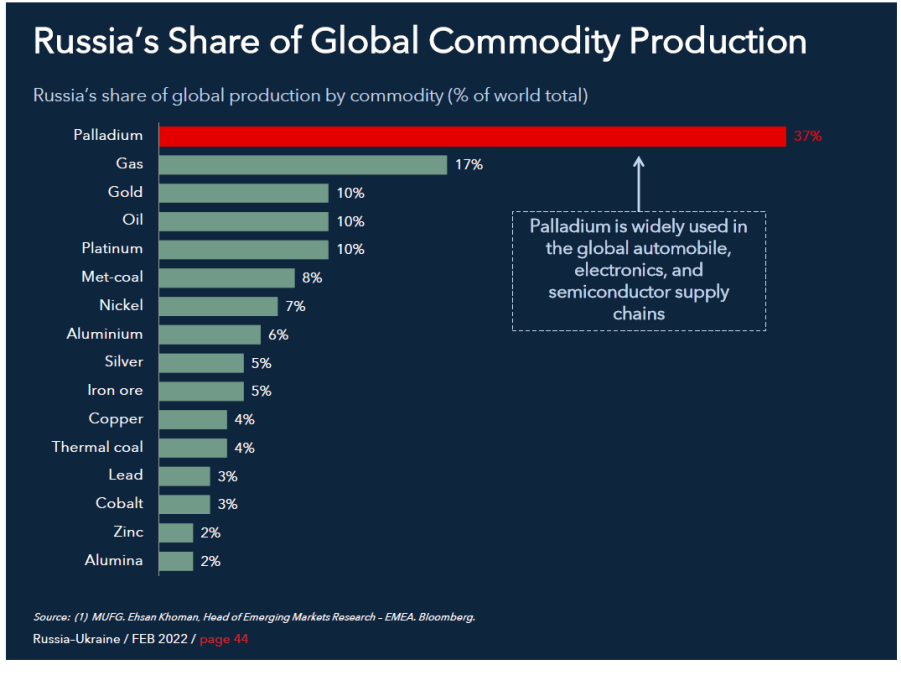
2022 Letter to Investors

Russian Invasion Shifts the Scenarios

- Stagflation is possible
  - Definition: Slow or negative growth coupled with rising inflation
  - Breaks the traditional link between supply and demand
- Caused by an exogenous shock
  - Example: 1970s Arab oil embargo
- A result of structural reduction in supply
  - Not caused by the business cycle
  - Rising prices continue until the supply impediment is removed
- Monetary policy has little influence on this kind of inflation
- Russia's invasion of Ukraine is creating shortages in commodities
  - Time will tell how long the shortages will last



Cascades Through to Finished Goods



Example: Potash, phosphorous, and nitrogen in fertilizer

Commodity Prices Shoot Higher

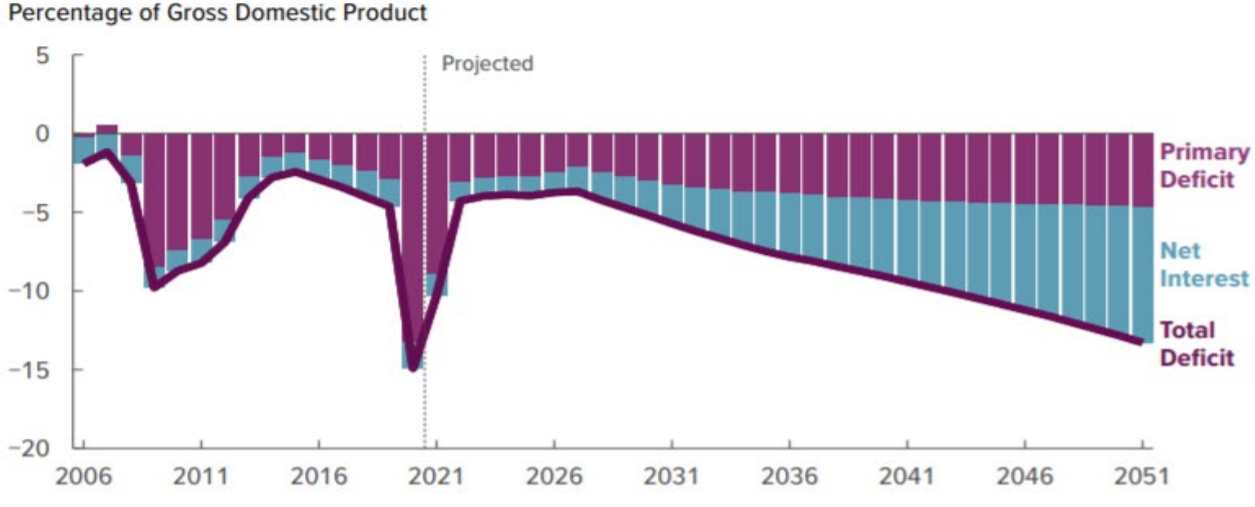
Post-Pandemic Adjustment Period

Structural Change

“Fiscatary” Policy

U.S. Deficits into Perpetuity

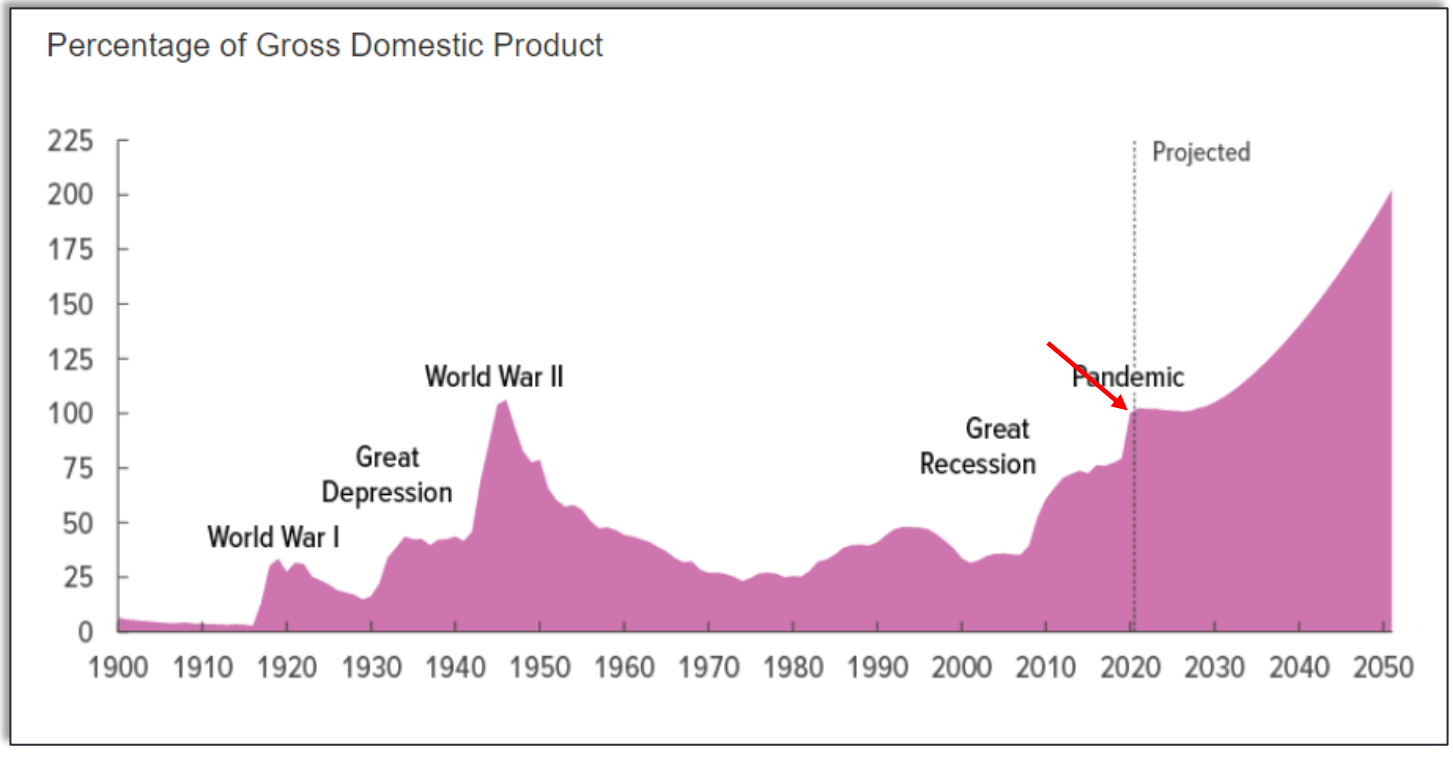
U.S. Budget Deficits



After decreasing as the effects of the 2020–2021 coronavirus pandemic wane, deficits grow, largely because net spending for interest increases rapidly in the last two decades of the projection period. Deficits exceed their 50-year average of 3.3 percent of GDP in each year of that period.

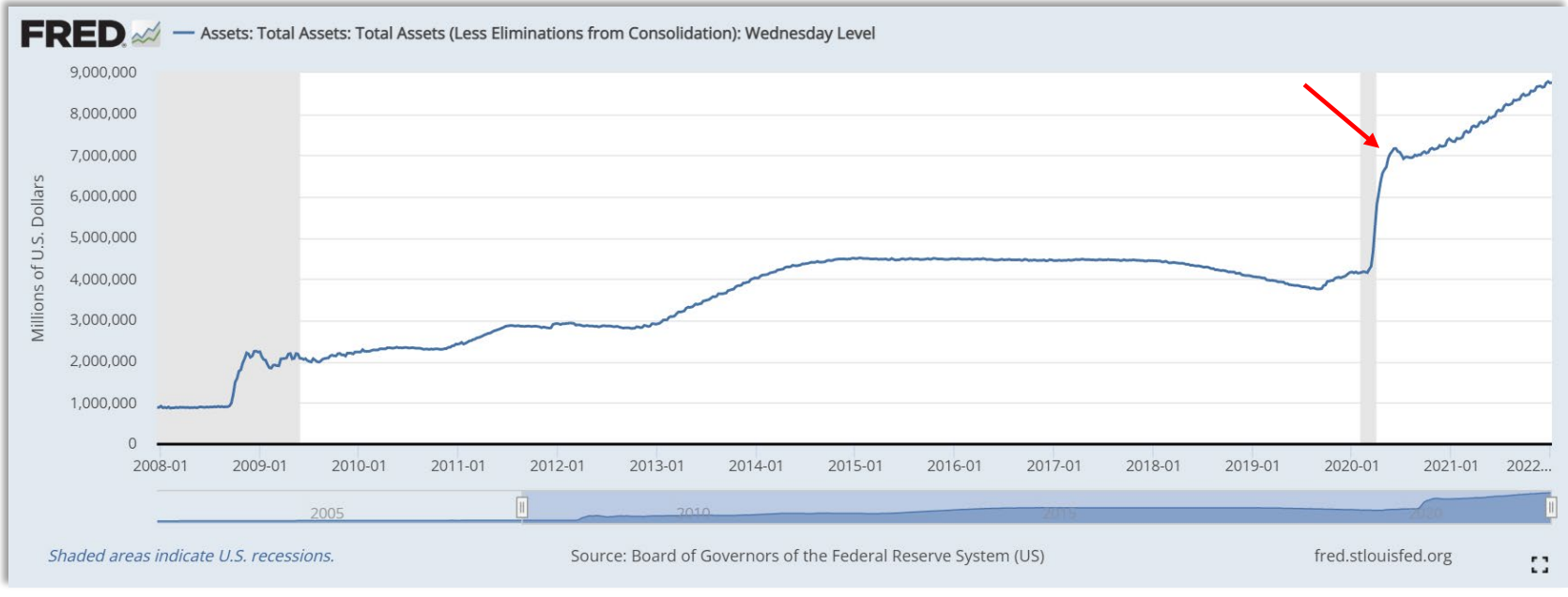
Source: U.S. CBO

U.S. Public Debt



Source: U.S. CBO

U.S. Fed Balance Sheet Explodes



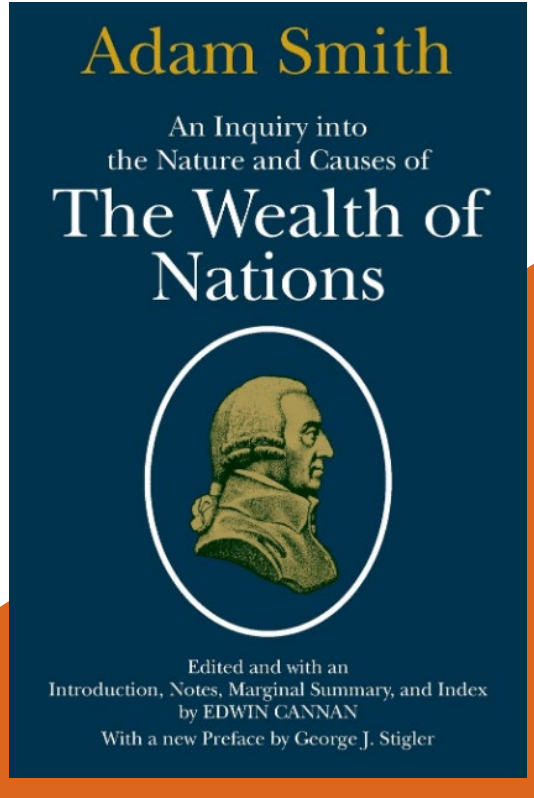
Implications of “Fiscatary” Policy

- Stronger economic growth via lower interest rates and bigger budget deficits
- Increases the government’s ability to respond to crises
- Distorts financial markets, especially bond yields
- Causes greater wealth and income disparity
- Does it create asset bubbles?
- Risks increased politicization of the Fed

Preeminence of Modern Monetary Theory

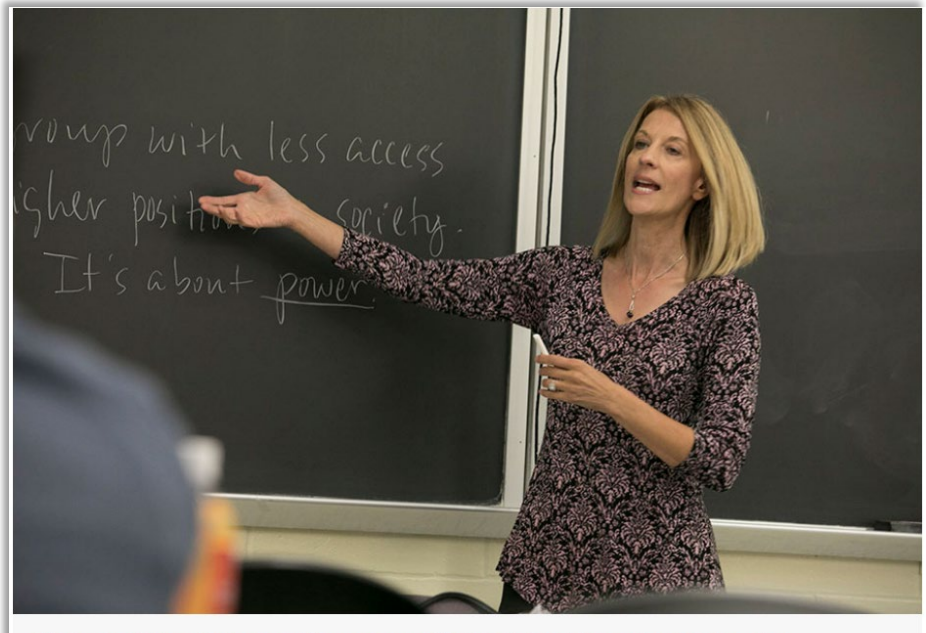
Adam Smith's

The Wealth of Nations



Source: University of Chicago Press

Modern Monetary Theory (MMT)



Stephanie Kelton, Professor of Economics and Public Policy at Stony Brook University

Has *The Wealth of Nations* been replaced by *The Deficit Myth*?

- MMT proposes that a country with its own currency can prudently spend itself to prosperity. Deficits should be embraced.
- The only constraint on spending is inflation, which can break out if public and private sectors spend too much at the same time.
- Governments don't have to worry about accumulating too much debt because they can print more money to service it.
- If there are enough workers and equipment to meet growing demand without igniting inflation, the government can spend whatever is required to maintain employment and achieve goals such as universal basic income, single-payer health care, and halting climate change.

Sources: Investopedia, Vice.com, Stony Brook University

Paradigm Shift

The Washington Post

Democracy Dies in Darkness

Analysis

Biden's first budget signals that deficits don't matter

The president's budget predicts a $1.8 trillion deficit for 2022 and deficits of $1.3 trillion for years to fund investments in infrastructure, education and the social safety net.

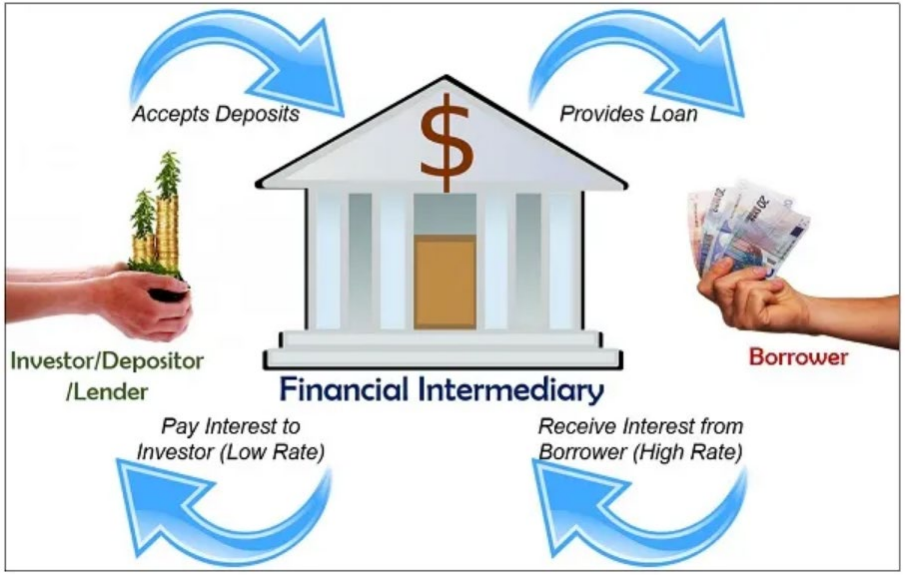
By Heather Long

Not "a problem to be solved later."

Source: WashingtonPost.com retrieved May 28, 2021

Decentralized Finance aka “DeFi”

Financial System Based on Intermediaries



Transaction ledgers are held at banks.

Counterparties must trust intermediaries for the system to work.

Source: Learner's Source

Decentralized Financial System

Trust in intermediaries is unnecessary in a DeFi system.

Source: Schroeders.com

Decentralized Financial System

Cryptocurrency values driven by:

1. Unbridled speculation

2. Concern about the sustainability of debt-ridden economies around the world

Labor Wins!

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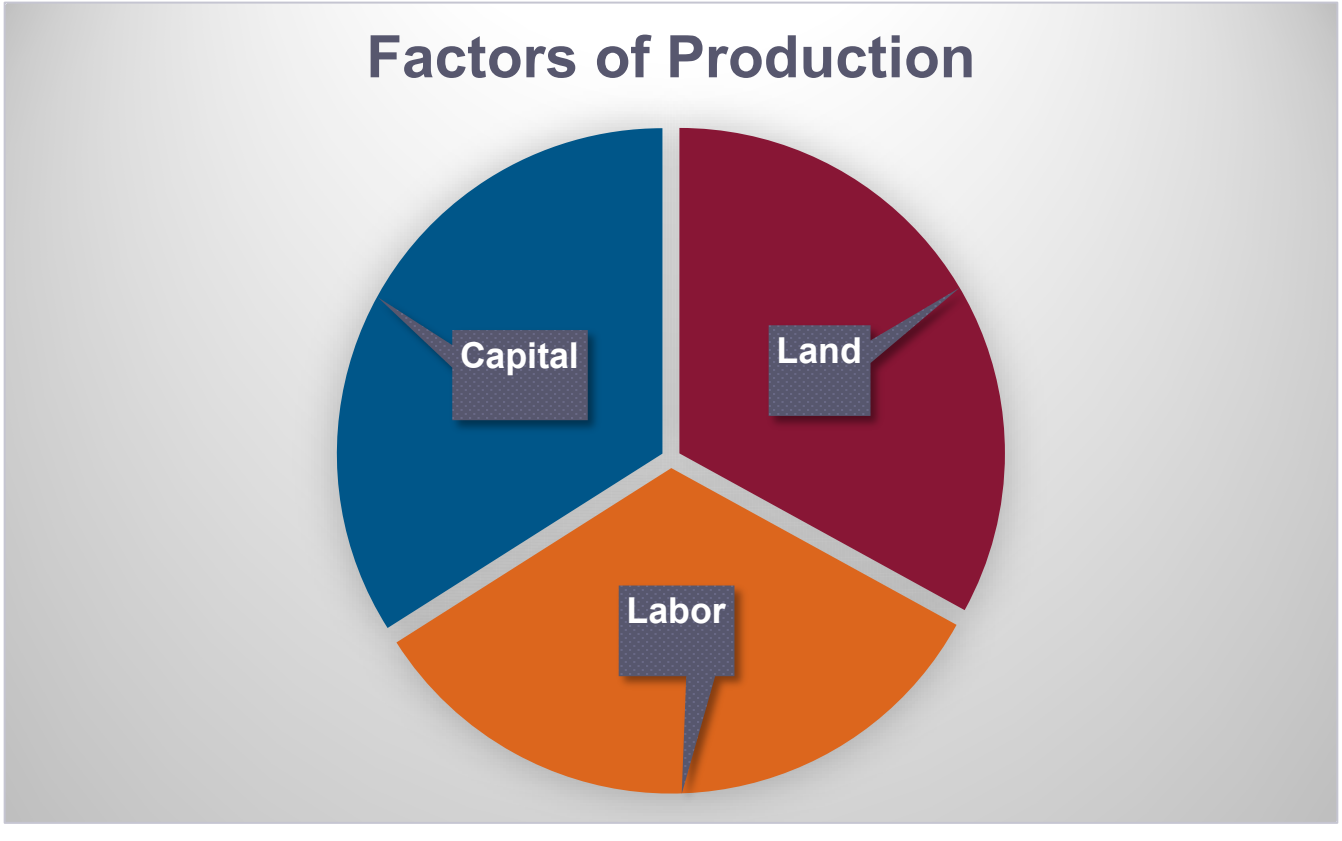

Labor Wins!

- The post-pandemic environment is reordering factors of production winners and losers
- Slow growth, disinflation, and negative real interest rates stacked the deck in favor of Capital and the investor class that provided it
  - Led to considerable wealth and income disparity
- With inflation percolating and a workforce that is much smaller than required, the stage is set for Labor to contend for the top spot
- Strong GDP could cause the current mismatch between Labor supply and demand to widen further
- If our textbooks are right, Labor's negotiation power will rise, causing its slice of the economic pie to grow
- Labor wins under this scenario, but it comes with higher overall inflation rates
- Wage costs are important inputs in overall output and costs

Reversal of Globalization and JIT

Broad Implications for Investors

Broad Implications for Investors

There is a case for added caution in 2022 versus last year:

- The economy is strong at the beginning of the year
- The trajectory of interest rates and inflation remains uncertain
  - Fiscal and monetary policy will likely be tighter, but will the tightness currently expected be enough?
- Numerator: Earnings will likely be strong, but YOY comps will get tough (-)
- Denominator: Negative real yields will likely come down (+)

Probabilistic questions: 1) What are the chances that 20+% earnings growth will continue and real interest rates will remain shockingly negative in 2022? 2) What is the state of the "Fed put"?

Summary

- The global economy and financial markets are highly distorted in the post-pandemic environment
  - Entering 2022 with a lot of momentum in both
- What should investors expect? It's all about inflation.
  - There are compelling reasons to believe inflation will be temporary and easily digested
  - There are also compelling reasons to believe inflation will be entrenched and disruptive
  - Russia's invasion of Ukraine increases the risk of stagflation
- Markets no longer discounting rising inflation that will be reigned in
  - Are they right? Herein lies the current biggest risk.
- The case for caution and modest expectations in 2022:
  - The probability of a repeat of 2021 is low
- The case for long-term optimism is firmly intact!

Important Disclosures:

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