CVP's 2022 Market Monitor and Outlook (Part 1) January 7, 2022: Rising Inflation and Interest Rates Threaten the Markets and Economy in 2022

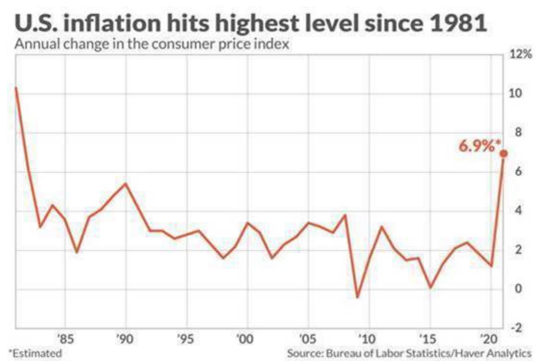
CREDIT VALUE PARTNERS

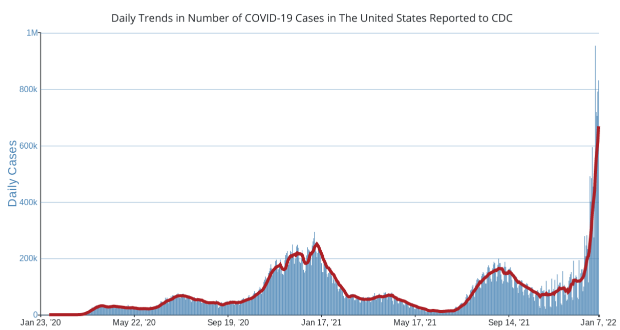
<u>Note: We are presenting our 2022 Market Outlook in two parts</u>: Part 1 focuses on our Economic Outlook and the implications of inflation on the markets. Part 2 (which we will publish later this month) focuses more specifically on the Corporate Credit markets and the likelihood of a new Credit Default Cycle.

<u>2022 Market Outlook (Part 1)</u>:

- *We expect the recent, negative economic developments, especially the rise of inflation and the Fed's hawkish response to it, to create significant economic headwinds and possibly usher in a new recession. When these economic challenges are taken into consideration with the current, over-extended conditions in the corporate debt and equity markets, we believe that it's increasingly likely that a major market dislocation and perhaps a new Bear market will develop in 2022.*
- *As we enter the year, we believe the markets have more downside than upside potential in the near term. The Fed has been flooding the markets with cash and cheap credit for several years now, and this has resulted in bubble-like conditions in multiple asset classes. Speculative excesses are now pervasive across the markets, resulting in heightened volatility and leaving the markets more vulnerable to a sharp and severe dislocation - similar to what we saw in the early weeks and months of the Financial Crisis and, especially, the Covid Crisis.*
- *Due to an alarming spike in inflation, the Fed has sharply reversed course and is now taking a decisively Hawkish stance. The Fed recently said that it sees inflation as a major risk to the economy, perhaps until 2024, and is now rapidly winding down its QE program. The Fed is also widely expected to take the Fed Funds rate up by 2% or more in a series of hikes, beginning as soon as March. Rising inflation and rising interest rates are threats to consumers, businesses and financial assets. Over the past several decades, they have consistently preceded major market corrections and recessions - we don't expect that this time will be different.*
- *In the absence of Systemic risk, we are not expecting the Fed to try to "rescue" the markets in any significant way when this next correction/recession unfolds. This is largely because of the clear evidence that its recent market bailouts have resulted in massive windfalls for the rich and materially worsened an already problematic wealth gap in the U.S. Without the "Fed Put", the next major correction would likely result in more meaningful and sustained losses to investors (especially levered investors) in higher risk assets classes, including private and public equities, real estate and speculative grade debt.*
- *For now, until the markets meaningfully re-price and/or the current inflation threat declines materially, we believe that investors should reduce their exposures to higher risk assets and focus more on lower-risk income investments and on raising liquidity. Allow the market cycle to run its course and revert valuations toward the long-term means. Once the correction is complete, we expect it to be followed by a more fundamentally attractive, multi-year investing environment. Investors armed with liquidity can then capitalize on far more compelling values with much less downside.*

In our September Market Monitor ("Topping Markets") we highlighted several indicators suggesting that the Corporate Equity and Debt markets were overvalued and ripe for a meaningful correction. We also featured three of the most likely catalysts to lead the markets down: 1. A renewed spike of Covid, 2. Escalating tensions with China and 3. Rising Inflation leading to rising Interest Rates. Since September, all three of these culprits have, in fact, escalated as potential threats to the markets and the economy. **Of the three, Inflation (and, relatedly, rising interest rates) has now clearly emerged as the largest and most serious risk to the Economy and Markets. Historically, rising inflation and interest rates have repeatedly preceded recessions and major market corrections. Despite this, the equity markets hit new, all-time highs in November and December:**





CVP 2022 Market Outlook – January 7, 2022

To read the full market outlook, please contact CVP at info@cvp7.com.

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