Review & *Outlook*

FOURTH QUARTER 2021

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Review and Outlook

In early 2021, we all hoped that COVID would subside so things could start returning to normal. But that optimism waned with the emergence of the Delta variant last summer, worries about inflation due to supply chain disruptions, and the discovery of the Omicron variant late in the year. At the start of the year, the U.S. economy grew at an annualized rate of roughly 6%, but slowed to 2% as the Delta variant surged in the third quarter. The National Association for Business Economics (NABE) expects growth in the fourth quarter will be closer to 6%, resulting in 5% growth for the year.[2] And that strong economic growth was matched by a 26% increase in the CRSP index, and an almost 29% increase for the S&P 500 index. This is good news in light of all the challenges of 2021.

A more nuanced picture emerges when you look past the headline benchmarks like GDP and the S&P 500. For example, unemployment fell from 6.3% in early 2021 to approximately 4% by the end of the year. But labor force participation rates remain low, especially for women and communities of color. Early retirements, fear of contracting COVID, and other factors have made it hard for many employers to find workers. Wages are up, but in many sectors, not enough to keep up with inflation.

Similarly, the strong performance of broad indices like the CRSP index does not mean all asset classes have performed equally well. The iShares MSCI All-Country World Index Excluding U.S. ETF (ticker ACWX) increased only 5% in 2021, the iShares MSCI Emerging Markets ETF (ticker EEM) fell over 3%, and the Bloomberg/Barclays Aggregate Bond Index fell almost 2%.

Index Performance Data
Total Return as of 12/31/2021

Indices[1]	Q4 2021	Trailing 12 Months
CRSP U.S. Total Stock Market Index	9.16%	25.72%
MSCI Global ex-U.S. Total Stock Market Index	0.34%	4.83%
Bloomberg Barclays U.S. Aggregate Bond Index	0.01%	0.03%

We anticipated that emerging markets would be hit hard by COVID, so we reduced our clients' exposure to global stocks this year. We sold positions of EEM in the fourth quarter, and are waiting to reinvest that cash, along with cash from fixed income securities that matured at the end of the year. With interest rates moving up, holding cash is currently a better option than reinvesting in bonds. We also positioned our clients' portfolios with a slight tilt towards value-oriented stocks, which finished the year ahead of the broad CRSP index.

As we think about the outlook for 2022, we look back on all the revised projections we saw in 2021. Economists have had to repeatedly revise their forecasts for growth based on what has been happening with COVID. They started with exuberant estimates in the spring, then revised them down as the Delta variant emerged. They also repeatedly had to increase their forecasts for inflation as supply chain disruptions and hiring challenges persisted longer than initially expected.

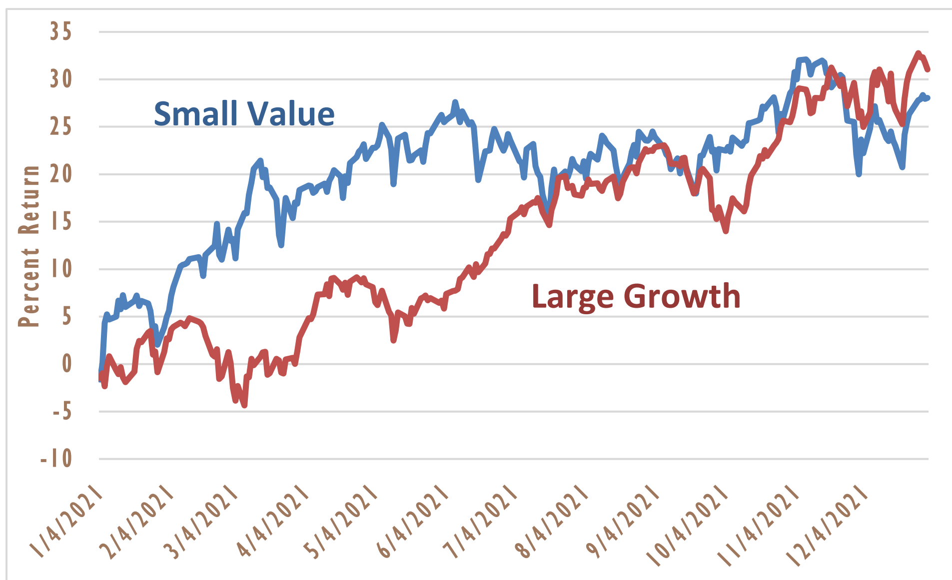
Just as the Federal Reserve, economists, and the markets were starting to look beyond Delta, Omicron hit; and the cycle of uncertainty around inflation and the Federal Reserve's decision to reduce their bond purchases started up again.

The most recent NABE forecast calls for the economy to grow 3.5% in 2022, with unemployment continuing to fall in the first part of the year. They anticipate that inflation will stay elevated in the first part of the year, then slow in the second half. But we believe inflation will start to slow sooner.

Since March 2020, the stock market has risen significantly, however there are strong cross-currents under the surface.

Much of this has to do with the outlook for future economic growth, as well as the level and direction of interest rates. In general, forecasts for higher interest rates have helped small and cyclical stocks, like materials, energy, industrials, and financials. That outlook is bolstered by the idea we are about to move beyond COVID, and that government stimulus will taper off. Meanwhile, growth stocks have tended to benefit from the idea that COVID is getting worse, so the government will try to keep interest rates as low as possible. Lower interest rates help support higher price to earnings ratios because future earnings are discounted less aggressively; earnings a long way down the road are worth more today in present value calculations. Additionally, some mega-cap stocks, like Apple and Microsoft, are increasingly viewed as defensive, like tobacco and Coca-Cola used to be.

The chart below shows a small-value ETF (ticker VB) and a large-growth ETF (ticker IWY). You can see how small-value stocks had strong relative outperformance from January through May. However, with Delta (and now Omicron) this trend reversed. By year end, the total return for growth stocks caught and passed small-value for the year.



The Omicron variant is highly contagious, but does not appear to be as virulent or as pathogenic as the Delta variant. If Omicron is less dangerous and allows for more normal economic activity, we expect market patterns will look, at least for a short period, as they did in early 2021. Increased vaccination rates, new medications that treat COVID, and more people contracting the less dangerous Omicron variant could allow us to find a new normal, which that could become visible in 2022. Investors could focus again on fundamentals, rather than business closures and liquidity-driven decisions.

In Focus

Expectations for higher inflation should lead investors to demand higher interest rates for money loaned out. Curiously, that has not happened. With all the talk of inflation in 2021, interest rates for key bonds like 10-Year U.S. Treasuries have not moved up the way you might expect.

The yield for 10 Year Treasuries moved from 0.94% at the start of 2021 to 1.74% in mid-March. The rate then fell back to 1.19% in August as the Delta variant hit the economy and made investors pessimistic about the future, and ended the year at less than 1.5%. For comparison, the rate was 1.88% at the end of 2019, just before COVID started to make headlines.

As the Federal Reserve reduces the amount of bonds it buys each month (their planned “tapering”), the Treasury may have to raise yields to attract buyers. Interest rates may move back up to levels more consistent with what we saw in 2019. Moreover, some people think the Federal Reserve also needs to raise short term interest rates to combat inflation. Adding to the complexity, U.S. bonds compete within a global bond market. Interest rates on bonds in many other countries are lower than in the U.S., so there may be a bit of a cap on how high interest rates will climb in 2022. Investors in other countries may decide that 1.6% or 1.7% yields on U.S. bonds are attractive and start buying more. This would be reinforced if inflation looks to be fading. More buyers would put upward pressure on prices and downward pressure on yields. This possibility aside, many economists see the yield on 10-Year Treasuries creeping back up towards 2.0% in 2022. So, what do we think this means for stocks?

The rise in interest rates in early 2021 could be an indicator of what to expect with stocks. Broad stock indexes did not suffer terribly when interest rates increased early that year, but high-priced stocks struggled. Apple fell almost 10% in the first three months of the year. Tesla increased noticeably in January 2021, then fell more than Apple as interest rates rose. And both Apple and Tesla did well later in the year as interest rates fell back below 1.5%. We imagine high priced stocks will drop again in 2022 if the expected increase in rates becomes reality. In late 2018, we also saw stocks struggle when interest rates moved up. Back then, the Fed reversed course and pushed rates back down to mitigate the impact on stocks.

One important question today is whether inflation is really going to be a problem in 2022. And embedded in that question is for whom inflation would be a problem. The Fed has said they are willing to let inflation rise above their target of 2% because having a little extra inflation can help bring up wages at the bottom of the wage scale, and we still need a growing economy to create jobs for the unemployed. The problem is that significantly higher inflation tends to hurt those living paycheck to paycheck more than others. It may be that the Fed's willingness to accommodate extra inflation is hurting those they say they want to help. The Fed is, understandably, being criticized for not acting fast enough to address inflation before it becomes a problem. Some add that the amount of money injected into the economy in recent years created the setting for serious inflation, and that supply chain constraints have ignited the fire.[3]

We think the Fed may ultimately be rewarded for their patience. Supply chain constraints showed signs of easing in the U.S., and inventories seemed to be adequate for large retailers during the holidays. As the demand for goods and services slows in the winter months ahead, upward pressure on prices due to supply chain problems should decline. (One risk to this view is that China could impose stringent lockdowns and close ports, disrupting supply chains, if challenges with COVID increase.) Moreover, the demand for a variety of goods and services may fall as the impact of stimulus funds fade. And finally, the rate of inflation will appear to slow simply because of the math. Year-over-year price changes looked extreme in 2021 when we were comparing the price growth to changes a year prior, during the early waves of COVID, when prices for many items had fallen. In 2022, we will be using a higher base, and the change will not be so high. We may even see prices falling in some instances, so the Fed may get credit for taking the right path.

If inflation does not turn out to be as problematic as some currently fear, interest rates will not increase dramatically. Still, we expect interest rates to increase a little, due in part to the Fed's tapering. That small increase in rates would affect stocks with high price multiples.

In the end, we do not anticipate dramatic increases in rates due to runaway inflation, which would be very challenging for the stock market in the short term. But we do expect rates to increase and some stocks to get repriced. As such, we are making adjustments to tilt our clients' portfolios towards stocks that are less likely to suffer price adjustments, and sticking with our emphasis on very high-quality, short-term bonds (and a little cash at times) on the fixed income side. We also expect attention will shift from inflation early in 2022. The news cycle will start focusing on the mid-term elections (and hopefully no new COVID variant). We may see additional volatility heading towards the elections, but believe investors will ultimately focus more on fundamentals, like actual corporate earnings and free cash flow, rather than grand speculative stories of positive earnings yet to come.

1. Index price and performance data is provided by Black Diamond Wealth Platform, an SS&C Advent product.
2. December 2021 Outlook Survey Summary. (n.d.). Retrieved January 4, 2022, from https://www.nabe.com/NABE/Surveys/Outlook_Surveys/december-2021-Outlook-Survey-Summary.aspx
3. Team, K. (2011, March 30). Stimulus is a recipe for inflation. Kiplinger. Retrieved January 11, 2022, from https://www.kiplinger.com/article/business/t019-c000-s001-stimulus-is-a-recipe-for-inflation.html?gclid=Cj0KCQiA8vSOBhCkARIsAGdp6RT6s7yAPgYaeGjMdPO4ix9bg-1tJItKGCRyAcQRH2Izf52IjgFHIK4aAs-VEALw_wcB

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