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MARKET PERSPECTIVES

QUARTER FOUR 2021

2021 was another strong year for the equity markets. Domestically, the S&P 500 finished with a total return of 28.7%, leading most other major asset classes. 2021 marked the third consecutive year of double-digit returns, which is impressive considering there was a severe economic contraction in the middle of it. There was some interesting rotation amongst the market leadership throughout the year as investors' worries pivoted between another COVID-induced economic slowdown and fears that inflation would run hotter than the Fed believes. These concerns drove investors to fluctuate between favoring value and growth stocks, with no clear winner emerging between the two.

International stocks lagged once again, with the MSCI ACWI ex-USA Index returning 7.8%; however, most of the benchmark's underperformance came from currency translation and emerging markets. China's equity markets, which represent the largest weight in most emerging-market benchmarks, had a tumultuous year. Both the country's zero-COVID policy, which led to more frequent and stringent lockdowns, and President Xi Jinping's sweeping regulatory changes rattled investors. China appears likely to stimulate its economy in 2022, perhaps providing investors willing to look past the current headlines a buying opportunity.

Bonds did not perform as well as stocks, likely on fears that the economic recovery would keep inflation elevated, which caused interest rates to rise. The Bloomberg Aggregate Bond Index returned -1.5%, breaking a string of seven consecutive years of positive returns. Municipal bonds managed to post positive returns, with the Bloomberg Municipal 1 – 10 Year Blend Index up 0.5%, benefitting from the strong fiscal position of most states and municipalities.

This is the time that most investors consider their outlook for the year ahead. As we were developing our expectations for the economy and investment markets in 2022, our focus immediately settled on two primary concerns: COVID and inflation. Even more important may be how global central banks navigate the uncertainty surrounding these two factors.

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The Fed May Be a Bigger Threat Than COVID

Most of us would likely place COVID at or near the top of our list of concerns. Last January, we were optimistic that wide-scale distribution of effective vaccines could finally put an end to the pandemic, allowing life to return to normal. A surge in new cases caused by the Delta and Omicron variants have tempered our optimism, however. Some experts suggest that COVID may be with us indefinitely, in a similar form to influenza.

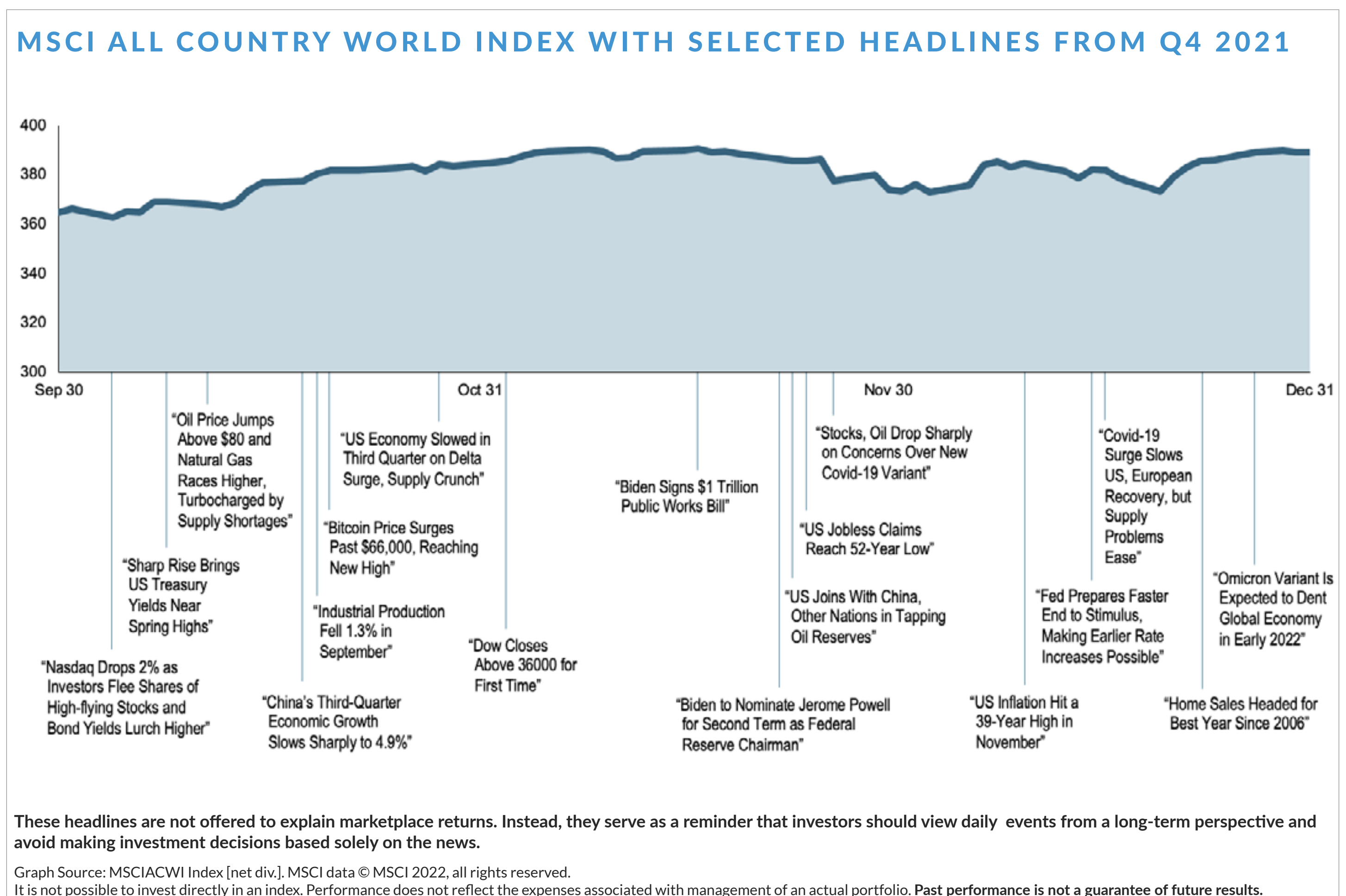
While the virus's trajectory is seemingly unknowable, we see reasons to be positive. Despite the Omicron surge in new cases having surpassed all previous increases, we have not experienced a similar acceleration in hospitalizations or deaths. Moreover, in December, the Food and Drug Administration (FDA) issued emergency use authorization for two antiviral pills that appear to be effective treatments for patients who have contracted the disease. Finally, the world may be nearing the point of herd immunity, due to both the rollout of vaccines and the recent surge in infections.

Regardless, most policymakers seem unwilling to reintroduce stringent lockdown measures like the ones put in place in March of 2020. People everywhere are weary of social distancing and mask wearing. In any event, there are reasons to be hopeful that in 2022 the worst of the pandemic will be behind us and the economy will continue its return to more normal conditions. In a recent letter, we suggested that, from the economy's perspective, COVID may no longer be a clear and present danger.

One of the most polarizing economic questions heading into 2022 concerns inflation. Supply-chain bottlenecks, higher energy prices, and rising wages all contributed to the U.S. inflation rate rising to 7% over the last year, its highest rate of growth since 1982. Economists disagree over whether inflation will remain high or return to pre-pandemic levels.

The Federal Reserve's (Fed's) outlook on inflation changed noticeably during the last couple months of 2021. For most of the year, the Fed maintained that inflation would be transitory as employees returned to work, helping to alleviate supply-chain pressures. In November, however, Chairman Powell surprised investors by telling lawmakers that "it's probably time to retire that word" as inflation is proving to be stickier than expected.

It may not be coincidental that Mr. Powell's shift occurred soon after he was renominated for another term as Fed Chairman. Inflation has become politicized, and President Biden's preference for a more dovish (favoring easy monetary policy) Fed was well telegraphed. With his nomination locked up, Mr. Powell was able to shift to a more hawkish (favoring tight money policy) posture at the December



These headlines are not offered to explain marketplace returns. Instead, they serve as a reminder that investors should view daily events from a long-term perspective and avoid making investment decisions based solely on the news.

Graph Source: MSCIACWI Index [net div.]. MSCI data © MSCI 2022, all rights reserved.
It is not possible to invest directly in an index. Performance does not reflect the expenses associated with management of an actual portfolio. **Past performance is not a guarantee of future results.**

meeting and announce a doubling of the pace of reductions of its monthly purchases of bonds, along with an increase to the median forecast for the number of rate hikes in 2022 to three.

WHAT THIS MEANS

As we write this, the economy has noticeably reaccelerated from its third quarter slowdown. Indeed, economists expect that real GDP growth increased from 2.3% to 5.5% during the fourth quarter of 2021. Assuming the impact of the Omicron variant on economic growth is not the headwind that the Delta variant was, we expect growth momentum to carry forward into the first quarter of 2022.

Nevertheless, the Fed has a difficult job ahead of it. Balancing economic growth against rising inflation is hard enough during normal times. The transition from treating the economic symptoms of the pandemic to the side effects from its policies is certain to make this time especially awkward.

Inflection points like the one the economy is undergoing right now are typically when policy mistakes occur. A close look at the Fed's history reveals an institution that has periodically been off with their policy maneuvers. We believe the uncertainty surrounding 2022's outlook means that the probability of this happening again is higher than normal.

Importantly, this does not necessarily mean that the market cycle is nearing an end. Equities have historically continued to climb during the first several interest-rate hikes, capitulating only when there is a belief that policy has gone too far. Most would agree that the Fed needs to begin unwinding some of the pandemic-related monetary stimulus, and Mr. Powell's inclination to overcommunicate suggests that the Fed's actions should not surprise the markets. Therefore, we expect that financial conditions should remain supportive even after the Fed starts raising rates. Additionally, economic growth is expected to remain materially above the average of the past decade. Recently, we have seen high-growth stocks, whose valuation reflects strong cash flows in the distant future, fall due to rising rates, which reduce the present value of these long-dated cash flows. It is likely that markets remain volatile as the Fed cautiously adjusts policy.

Wall Street vs. Main Street

Wall Street and Main Street have a complicated relationship. Counterintuitively, what is good for one is sometimes bad for the other. Why is that?

"Main Street" is a term economists frequently use to refer collectively to small businesses and consumers. This faction wants low unemployment, good wages, strong economic growth, and stable prices. While Main Street benefits from a rising stock market and home prices, a phenomenon commonly referred to as the wealth effect, its interests sometimes collide with the interests of Wall Street.

What is described above is not necessarily an ideal environment for "Wall Street," which broadly refers to the financial markets and the firms that participate in them. Given investors' fondness for companies that exhibit above-average growth, it might be hard to believe that too much growth could have a negative, albeit typically short-lived, impact on the markets.

Generally speaking, a strong economy with accelerating hiring and rising wages is associated with higher inflation. This is because a brisk economy usually results in an increase in demand, which tends to push prices higher. Consequently, rising inflation leads to rising interest rates as the Fed endeavors to keep the economy from overheating. As we mentioned in the prior section, rising rates often cause stock valuations to compress as future cash flows are worth less when discounted to today's dollars using a higher interest rate.

Conversely, a weak economy causes an opposite chain reaction. As growth slows, investors expect that the Fed will reduce short-term interest rates, causing long-term yields to fall also. This ultimately leads stock valuations to expand.

Valuations are only half the equation in deriving a stock's return. A company's earnings growth is equally important. Often during inflection points earnings growth and valuations move in opposite directions. Indeed, in 2021, the S&P 500 price-to-earnings multiple, a commonly used valuation measure, contracted by 7.6%, but earnings growth of 34.5% offset this valuation contraction, leading to the index appreciating by 26.9%. So, strong growth may lead to rising earnings but a lower valuation placed on those earnings, while weaker growth may cause lower earnings but higher valuations on those earnings.

There are other variables that may impact earnings and valuations outside of the economy and interest rates. Nevertheless, those two components are by far the most influential factors driving stock prices today.

WHAT THIS MEANS

It is possible that we experience two different market regimes during 2022. We head into the new year with some economic momentum, assuming the Omicron variant does not slow growth too much during the first quarter. The Fed's hawkish shift has some market participants expecting a rate hike as soon as March. Interest rates are already starting to rise in anticipation, causing the volatility we have experienced thus far in January.

The Fed watches financial markets closely when determining policy. If the markets' reaction to tightening policy becomes too painful, based on recent history, the Fed is likely to pull back on rate hikes. Market participants refer to this as "the Fed put," a reference to the option markets and the Fed's inclination to put a floor under stock prices.

The Fed may also refrain from additional rate increases if inflation shows signs of decelerating. Regardless of why, if the Fed does go on hold, it should create a positive backdrop for equities.

Earnings and the economy are still recovering from the pandemic. We expect above-average growth from both in 2022. The swing factor will be interest rates. With an underpinning of solid earnings growth, stocks should continue to trend higher. The Fed, however, holds the key to how high they will go.

Conclusion

As we head into 2022, the setup for the investment markets is mixed. Global economic growth is solid, and many countries have not yet reached their pre-pandemic level of economic activity. In addition, financial conditions should remain supportive of risk assets even assuming the Fed and other central banks follow through on reducing quantitative easing and raising interest rates.

Investors will need to be more vigilant in 2022, however. We are hopeful that the worst of the pandemic is now in the rearview mirror. As such, the economy should continue to normalize. Central-bank policymakers have the difficult task of trying to maintain full employment and stable prices so that Main Street can prosper. This will not be an easy transition given Wall Street's obsession with monetary policy. We believe the Fed will be careful not to tighten conditions too quickly. This could make for a year of decent returns, albeit with higher volatility, as investors adjust to the rapidly evolving investment landscape.

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