Investment Newsletter

Fourth Quarter 2021

The S&P 500 performed strongly during the quarter, concluding an exceptional year. The S&P 500's total return of +28.0% for 2021 was the sixth-best performance since 1990, and the index posted the fourth-lowest intra-year pullback (-5%) over that period. International markets, however, significantly underperformed U.S. indices, as Europe struggled to contain the pandemic and growth suffered.

The strength in the U.S. was driven by extraordinarily strong earnings growth for the year, diminished odds for hikes to federal, corporate or personal income taxes, the Federal Reserve opting not to fight rising inflation as aggressively as expected in the near term, no new lockdowns in the U.S. despite higher COVID-19 new infections tied to the new Omicron variant, and China thus far successfully managing a slow-rolling default of its over-indebted property sector.

Index	4th Quarter	2021
Equity		
S&P 500	+10.91%	+28.04%
MSCI All-Country World ex-U.S.	+1.82%	+7.79%
Fixed Income		
Bloomberg Barclays U.S. Intermediate Government/Credit	-0.57%	-1.44%
Bloomberg Barclays Municipal Bond 1-5 Year Blend	-0.03%	+0.35%

In fixed income markets, volatility continued to characterize the Treasury market as investors reacted to rising inflation and the subsequent tightening of monetary policy. With higher yields across the curve, all Treasuries with maturities over one year posted negative returns for the year. Shorter maturities outperformed longer maturities, with the 30-year Treasury posting a sharp decline of -4.6%. Other taxable bond sectors such as corporate and mortgage-backed securities also posted negative returns for the year. By contrast, both taxable and tax-exempt municipal bonds posted positive returns amid high demand and reduced supply.

The Federal Reserve is just beginning to remove its ultra-accommodative monetary policy by tapering its monthly net asset purchase program and by raising interest rates. The former is expected to conclude in March – a few months earlier than expected – and the latter is expected to begin the same month. As such, we expect to see continued upward pressure on yields. Consequently, our fixed income portfolio strategy remains defensive. We continue to target a short average duration and maturity, with an emphasis on high-quality bonds. As always, capital preservation is paramount in a rising interest rate environment.

Going forward, it is reasonable to expect the investment environment for equities to continue to be favorable, especially given the low level of interest rates, which makes bonds relatively less attractive. Even with rising inflation, equities have historically outperformed inflation 60% of the time going back to 1971.

However, it is also reasonable to expect the drivers of recent stock market performance to become more challenging going forward. Specifically, the benefits of fiscal policy are fading, monetary policy is tightening, both corporate earnings and real GDP growth in 2022 are forecasted to decelerate, and the stock market's valuation is elevated.

On fiscal policy, the nearly $5 trillion Build Back Better Plan has stalled in the Senate and COVID-19 benefits have largely been exhausted. President Biden did, however, extend the suspension of federal student loan repayments for an additional 90 days to May 1. On monetary policy, investors currently expect the Federal Reserve to raise interest rates to a level between 0.50% and 1.50% by September from 0.05% today.

S&P 500 earnings growth is forecasted to decelerate significantly to +8.5% in 2022 from +49.2% in 2021. The biggest driver of that deceleration is the exceedingly difficult year-over-year comparison driven by the reopening of the U.S. economy in 2021. In fact, the +49.2% growth rate in 2021 is the highest number in at least the last 25 years. Real GDP growth is also forecasted to decelerate to +4.0% in 2022 from +5.6% in 2021.

The valuation of the stock market remains elevated. While the S&P 500's current forward price-to-earnings ratio of 20.6x is at a -15% discount to its all-time high of 24.3x in 2000, the index trades at a +26% premium to its 26-year average forward price-to-earnings ratio of 16.4x. Moreover, when valued on other metrics such as cash flow or sales, the index is trading at all-time highs.

Despite these challenges, there are several positive factors to note: monetary policy conditions are still highly accommodative and household balance sheets are healthy, estimated corporate earnings and real GDP growth for 2022 are still robust, the Omicron SARS-Cov-2 variant could accelerate the demise of the pandemic, and inflation has easy comparisons and should decelerate. In addition, labor shortages and global supply chain bottlenecks, while persistent in the short term, should begin to ease more, and the global economy has yet to fully reopen – all critical drivers of future economic growth.

For S&P 500 earnings growth, it has averaged +7.7% over the last 25 years. In that context, the projected +8.7% earnings growth for 2022 is a favorable number, and one that could ultimately prove conservative.

Despite weighing on economic activity in the winter months, the Omicron variant has not led to new lockdowns in the U.S., and could help accelerate the demise of the pandemic. Omicron is far more contagious, but less severe than Delta, the previous dominant variant. For example, despite new infections being up a whopping +86% last week versus the same week last year when the virus had originally peaked, new hospitalizations and deaths were down last week -10% and -54%, respectively, versus the same week last year. Medical innovation also continues apace with new COVID-19 anti-viral pills from both Pfizer and Merck. Interestingly, stocks leveraged to the pandemic are looking past Omicron, with travel stocks performing well and COVID-19 test and vaccine makers performing poorly on a year-to-date basis.

Unlike corporate earnings and real GDP growth, inflation actually has easy year-over-year comparisons. The Federal Reserve expects inflation, as measured by the Personal Consumption Expenditures Index (PCE), to rise to +5% for 2021 versus an average of +1.8% since 2000. For context, +5% for 2021 would be the highest level of inflation since +5.2% in 1984. As long as the Federal Reserve continues to tighten monetary policy and labor markets continue to normalize, inflation growth should recede going forward.

With an increasingly challenging investment environment, coupled with considerable investment gains that have accrued in client portfolios, clients should expect to realize larger-than-normal capital gains this year. Our key focus remains driving success over the long term by investing, with discipline, in stocks with good risk/reward profiles. We do this by selecting stocks with the most compelling secular trends, with good business models, whose fundamentals are stable or improving, whose ESG Risk Ratings are favorable, and whose valuations are reasonable.

Sources: CDC, Johns Hopkins, Federal Reserve Economic Data (FRED) and FactSet