JANUARY 2022

Investment Review and Outlook

KEY TAKEAWAYS

- A strong economy, record-breaking stock market, and rising inflation were the hallmarks of 2021. Although we expect positive economic growth in 2022, COVID-19 and its variants will impact the path forward, both domestically and globally.
- Some inflationary pressures are expected to persist, but many are likely to decline due to supply chain repair and Federal Reserve actions.
- The US consumer is driving the economy, and companies challenged by supply chain bottlenecks and labor shortages struggle to keep up with robust demand.

Total Returns & Values As Of 12/31/21

	QTD Return	YTD Return	Price/ Value
Dow Jones Industrial Average	7.9%	20.9%	36,338
S&P 500 Index	11.0	28.7	4,766
Russell 2000 Index	2.1	14.8	2,245
MSCI EAFE Index	2.7	11.8	2,336
MSCI EM (Emerging Markets)	-1.2	-2.2	1,232
Bloomberg US Aggregate	0.0	-1.5	105
Bloomberg Municipal Bond	0.7	1.5	114
Gold (NYM $/ozt) Continuous	4.1	-3.5	$1,828.60
Crude Oil WTI (NYM $/bbl) Continuous	0.2	55.0	$75.21

Source: FactSet

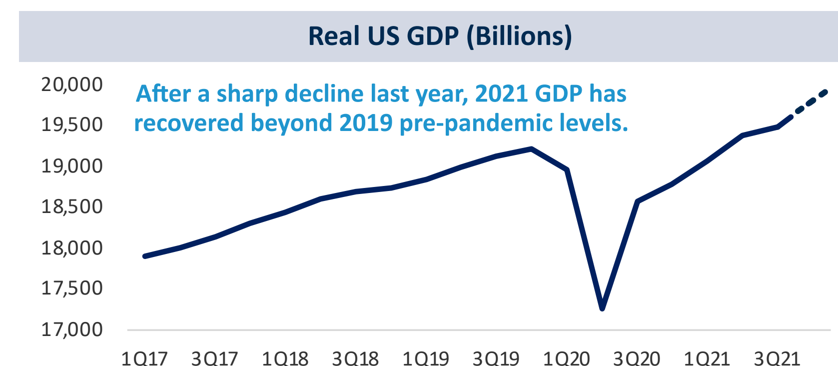
THE ECONOMY

A Strong US Economy Prevails

Issues surrounding COVID-19, particularly the new Omicron variant, dominate the headlines as we begin 2022. Inflation, supply constraints, and labor shortages only add to the uncertainty for both consumers and corporations. Despite these challenges, the US economy saw strong growth in 2021, with an estimated 5.5% GDP growth rate. Overall, the American consumer and US corporations seem to be in solid financial positions.

We expect strong growth in 2022 if the global economy can fully reopen but, as always, will closely monitor developments across the economy and markets. We also note that 2022 brings US midterm elections, with political rhetoric adding to the headline noise that might spark periodic market volatility.

Real US GDP (Billions)



Source: Federal Reserve Bank of St. Louis

Recognizing The Strength Of The Consumer

At the heart of the US economy is the American consumer. While we have seen consumers begin to spend some of their accumulated savings and increase credit card usage, in general, they still have significant financial bandwidth. A record-breaking stock market and rising home equity from house price appreciation have bolstered consumers financially, while the labor shortage only adds to confidence levels. The labor market is strong. Wages, particularly at the lower income levels, are growing, fueling increased spending in the heavily consumer-driven US economy.*

Inflationary Pressures Persist

Inflationary pressures have been fueled by supply constraints, labor shortages, rising wages, and pandemic-related stimulus programs that have stoked demand. However, unlike the rampant inflation that persisted throughout the 1970s and 1980s, we expect these inflationary pressures to diminish over the course of 2022 and 2023 as monetary policy measures kick in, supply chains recover, and demand normalizes.

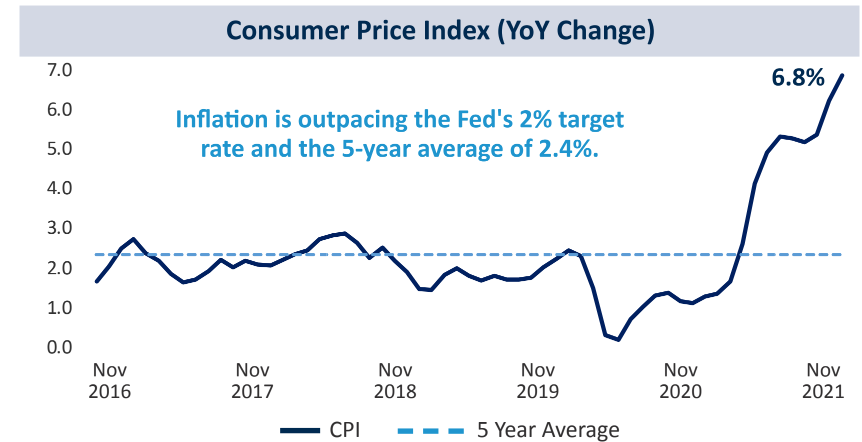
The loss of purchasing power due to inflation has a significant impact on lower-income groups who, by necessity, generally spend a higher percentage of their income on living expenses. Retirees, also on fixed incomes, are similarly affected. It also hurts investors if the Fed raises rates as a cure.

The Fed's Response

In response to unexpectedly higher inflationary pressures, with inflation reaching 6.8% year-over-year as of November 30, 2021, the Fed plans to double its upcoming tapering of Treasury and mortgage-backed securities purchases by $30 billion/month (from $15 billion/month) and announced the end date of their purchasing program as of March, 2022 (3 months earlier than originally planned). Post-tapering, the Fed is considering up to three Fed Funds rate hikes in 2022 to further quell inflation.

The Fed's policy directives will take time to work their way through the economy. Inflation ultimately should revert towards the Fed's 2% target rate, as supply bottlenecks resolve, demand fervor wanes, and the economy normalizes.

We anticipate three increases of 0.25% in 2022, with the potential for more hikes in 2023 and 2024 if needed. The Fed is attempting to engineer a soft landing by gradually putting the brakes on inflation and avoid triggering a recession. Historically, this has proven to be a difficult task.



Source: Federal Reserve Bank of St. Louis

Supply Chain Concerns

While consumer demand remains strong, many companies are unable to produce goods fast enough to meet both heightened current demand as well as the backlog since the start of COVID. Supply chain issues and bottlenecks in US ports persist, resulting in many companies double-ordering supplies, having factored in the time it may take to receive them, which is exacerbating the problem. As a result, many businesses are challenged by rising raw materials, labor, and transportation costs. Many of these companies have been able to pass on these rising costs to consumers and to maintain operating margins. If, as expected, demand subsides, manufacturers who have double-ordered materials may experience an inventory bulge possibly leading to price-cutting in order to move excess stock later in the year. Although supply chain constraints likely will remain through the first half of 2022, order rates are strong, which bodes well for economic growth.

Finding Labor

A shortage of workers is an issue across industries. The ratio of job openings to the number of unemployed in the US is nearing a 70-year high. Many businesses struggle to find qualified candidates to fill positions at all levels, resulting in rising wages. The pandemic provided the opportunity for many people to rethink their overall employment and approach to quality of life. It also accelerated retirement for many workers who, understandably, are more comfortable retiring when their 401(k)s, investment account balances and home values have grown, and they have stockpiled savings.

THESE ACCELERATED RETIREMENTS, COMBINED WITH REDUCED IMMIGRATION DURING THE PANDEMIC, HAVE IMPACTED LABOR SUPPLY IN THE UNITED STATES.

These accelerated retirements, combined with reduced immigration during the pandemic, have impacted labor supply in the United States. As the digital transformation of the American economy progresses, many companies will explore technological solutions and automation to decrease labor dependency.

Wage disparity also has been a topic of conversation in terms of what employers are paying existing employees versus what they now have to pay to attract fresh talent. While that situation has been most evident at the lower end of the wage scale in service industries, it has begun to broaden to numerous industries as well as higher-skilled positions.

Low Rates Lift All Boats

Low real interest rates have buoyed all asset classes. Abundant central bank liquidity boosted asset prices and generated above-average portfolio returns. Investors enjoyed one of the strongest equity market rallies in history and, chasing better yields, ventured into alternative investments, including real estate, private equity, and private debt. In addition, cheap credit led to debt-funded equity buybacks, and increased mergers and acquisitions activity. Currently, equities are expensive, bonds are highly valued with low nominal yields and negative real yields, private equity valuations are at the higher end of their range, and real estate has enjoyed historic gains.

Bitcoin Interest & Potential Regulation

Cryptocurrency has continued to attract significant attention and capital, due to both its increasing liquidity, fungibility (the ability of an asset to be interchanged with another asset of the same type), and scarcity (bitcoin has a limited supply). Currently, with thousands of cryptocurrencies available, the total market capitalization for cryptocurrencies, in aggregate, is $2.3 trillion. However, in terms of volatility, the risks are significant. The degree to which crypto will ultimately be subject to government regulation is also a key concern.

THE EQUITY MARKET

Business Resilience & Margin Expansion Exceeds Expectations

The big surprise for the equity markets in 2021 was the resilience of companies during the pandemic. The ability of businesses to manage through COVID-related disruptions led to much better than anticipated profit margin expansion and earnings growth. As a result, the equity markets performed better than expected. Persistently low interest rates have driven investors to the equity market as there were few alternatives to stocks for growth.

Growth Story With Profits Matters

Renewed virus concerns and a spike in inflation are impacting the equity market. Volatility has reappeared and has been unsettling for many investors, with a maximum drawdown of 4% between October and year-end. The emergence of new COVID-19 variants has contributed to investors becoming more selective. As a result, valuations of highly-valued companies that are not yet profitable but trade purely on a price-to-sales basis have compressed. Repricing of these companies occurred in late 2021 as investors became less willing to accept high multiples on unprofitable companies.

Investors' appetite for profitable companies with the potential for sustainable growth is likely to continue. Select companies in specific sectors, including healthcare, technology, consumer-related, and ecommerce have characteristics that lend themselves to sustainable,

profitable growth. We believe that earnings do make a difference in informing stock valuations and are an important indicator of future capital appreciation.

Expect More Volatility

Pockets of speculation in 2021 saw meme stocks riding a rollercoaster of volatility fueled by enthusiastic day traders. These retail investors played a more significant role in 2021 than they probably have at any other time in history and will do so going forward.

In addition, high valuations and market concentration were factors in market returns this year. Currently, Apple, Microsoft, Amazon, Meta Platforms (formerly Facebook), NVIDIA, Tesla, and Alphabet make up about one-quarter of the value of the S&P 500 and nearly 40% of the NASDAQ. They also contributed to a significant part of the S&P 500's return, making up 35% of the return. Current elevated valuations likely will lead to below-average market returns for the next few years.

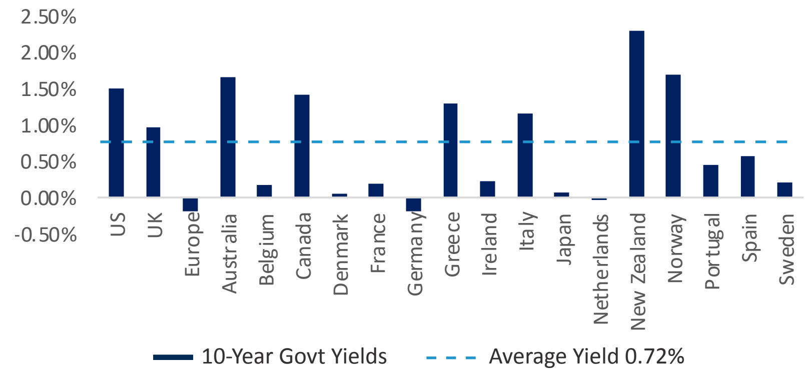
Rising inflation resulting in higher interest rates has the potential to reduce price-earnings multiples for growth stocks. This adjustment is often the cause of some volatility in equity portfolios. However, we expect current price-to-earnings multiples to decrease only modestly in 2022 as inflation settles into the 2-3% range and rate increases are likely to be gradual.

THE FIXED INCOME MARKET

Rising Interest Rates

With the Fed's potential implementation of up to three interest rate hikes to quell inflation in 2022, we expect the 10-year Treasury rate, currently at 1.51% to rise to the low 2% range. However, when factoring in inflation, this level still will result in negative real rates (real rates equal the nominal rate minus the rate of inflation). From a global perspective, US Treasuries should attract yield-starved foreign investors from countries experiencing negative nominal rates. Due to inflationary concerns, the Fed probably will be among the first of major central banks to implement tightening, keeping US Treasuries attractive relative to the rest of the developed world.

10-Year US Govt. Bond Yields versus Foreign Govt. Bond Yields



Source: Factset as of 12/31/21

An Update On Corporate & Municipal Bonds

Corporate bonds remain strong, and spreads relative to Treasuries are tight. The challenge remains for the taxable bond markets to produce meaningful yield. 2021 saw healthy corporate bond activity as companies sought to raise capital at lower rates as inflation started to take hold, with a total gross issuance of approximately $1.4 trillion as of December 2021. While that amount is below the record issuance of close to $1.9 trillion in 2020, it is above the $1.2 trillion for 2019.** We do not expect corporate bond issuance in 2022 to be as robust.

Demand for individual municipal bonds was high in 2021, as investors sought to invest ahead of any potential 2022 tax rate increases, while issuance did not keep up. We are hopeful that the new infrastructure bill and any projects implemented as a result, will spark additional municipal bond issuance over the next few years for additional funding needs. The bill also expands the limits on private activity bonds, allowing communities and municipalities to partner with private corporations on specific projects.

A Word About TIPs

In a rising inflation environment, investors may look to TIPs (Treasury inflation-protected securities) as a potential investment solution.

However, real yields on TIPs are sharply negative in the current environment, meaning any positive return will be the result of the principal accrual determined by future rates of inflation. With TIPs, it is the face value that is adjusted according to changes in the Consumer Price Index. While recent inflation data certainly has been high over the last year, there is no guarantee the pace of price increases will be maintained once supply chain issues are resolved. Additionally, in a taxable account, investors must pay taxes annually on the principal adjustment determined by future rates of inflation despite receiving no proceeds until the bond matures or is sold.

Given the uncertain outlook for inflation once pandemic-driven dislocations are resolved, other investment strategies may be more desirable. For example, investors may turn to the traditional five-year Treasury note, which recently has sold off, compared to the richly valued TIPs securities. Traditional Treasuries provide positive cash flow, compared to the negative yielding TIPs, as well as less complexity, greater liquidity, and slightly better returns should inflation settle into a mid-2% annual rate over time as we expect. However, the greatest protection against inflation over the long term is still the growth potential provided by high-quality equities, particularly among dividend payers that traditionally raise payouts as nominal earnings grow.

IN THE NEW YEAR

Investing using a needs-based approach tailored to more immediate cash flow requirements and longer-term growth goals is key. At 1919, we remain focused on helping our clients navigate market challenges and benefit from the opportunities in an always unpredictable investment environment.

High equity market valuations and many of the cross currents mentioned in this Investment Review and Outlook may contribute to heightened volatility and short-lived, but dramatic pullbacks in the equity market over the next year or so. However, over a longer time horizon, equities still offer superior growth potential.

High-quality bonds and cash equivalents will play an important role in mitigating portfolio volatility and funding more-immediate cash flow needs. In light of a persistently low-rate environment, a fixed income allocation has become more about principal preservation, portfolio diversification, and providing ballast to an equity allocation rather than a compelling income-generating solution.

As always, we remain focused on your long-term goals and encourage you to keep the same perspective. Please keep us informed about upcoming cash needs and we will keep you informed of any significant changes to our outlook. We wish you and your family health and prosperity in the new year and for many years to come.

** Source: Bloomberg.*

***Source: Bank of America*

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