

ECONOMIC OUTLOOK

Summary

As we close the chapter on another year and reflect on all that occurred, it's easy to conclude that 2021 was a unique year. While enduring through a variant-riddled pandemic, the economy saw massive nominal growth to go along with the largest inflationary spike in decades. Additionally, there was an enormous amount of global government spending combined with easy monetary policy. Overall, it turned out to be a prosperous year for the equity market, though slightly less so for fixed income. The economy was on fire for the majority of the year but will it continue to be as scorching hot during 2022?

It's certainly possible but if we were to hypothesize on an economic theme for 2022, a reasonable suggestion could be "the removal of accommodation". On the monetary side, the Federal Reserve has already outlined the ending of their bond purchases (QE) in March. They also expect three 25 basis point increases to the Federal Funds rate this year, according to their Summary of Economic Projections. On the fiscal side, we are seeing the removal, or unwinding, of some of the stimulus measures implemented during 2020 and 2021. For example, direct relief payments to citizens are not expected for the first time in two years, and the Child Tax Credit is set to return to its pre-pandemic amount, which will likely make wallets a bit thinner. Additionally, expanded unemployment benefits, eviction moratoriums, and PPP loans are no longer in place, and student loan interest and payments are set to resume – potentially pinching wallets even further. We've already seen the savings rate return to its pre-pandemic level, suggesting people now have less to spend, and therefore less to contribute to overall economic growth.

Yes, there is the bipartisan infrastructure bill that was passed late last year but any economic benefits from it will be seen over many years, unlike other recent stimulus. Also, Build

Back Better, which was originally expected to cross the goal line in 2021, is still questionable in any form. At least for now, it appears the massive economic tailwind provided by government spending is over.

However, this isn't a bad thing. The economy has recovered from the depths of the pandemic and remains in a solid position. Growth will likely continue in 2022 and it is a positive we no longer require crisis level monetary and fiscal stimulus. That being said, we would temper expectations for the economy to continue on the same torrid pace as last year.

Positives

Initial jobless claims have returned to pre-pandemic levels (about 200k per week)

ISM Prices Paid were well below estimates (68.2 vs. 79.3 est)

Average hourly earnings continue their ascent (0.6% vs 0.4% est.)

Negatives

There was a sharp decline (though from elevated levels) in the ISM Services PMI (62 vs 67 est.)

Retail sales trailed expectations during November (0.3% vs. 0.8% est.)

Payroll growth was less than anticipated (211k vs 400k est.)

EQUITY OUTLOOK

Summary

The S&P 500 rebounded from a slight decline in November climbing 4.5% in December and hitting an all-time record high in the final week of the year. During the month, the Russell 1000 Value index rose 6.3% outpacing the 2.1% gain of the Russell 1000 Growth index. Value stocks were led by higher dividend paying consumer staples, real estate and utilities sectors, each climbing around 10% as interest rates fell in December. The major large-cap indexes, the S&P 500, Russell 1000 Growth and Russell 1000 Value, closed 2021 up 28.7%, 27.6% and 25.1% respectively. Those returns for the year are both impressive from an absolute standpoint and surprisingly comparable given the style differences.

As we roll into 2022, many of the market themes that have driven direction remain the same but are likely to evolve throughout the year. The FED remains accommodative but is expected to become gradually less so. Supply chain concerns are being stressed further by COVID-related staffing issues, yet it's likely we are nearing a peak and these issues will slowly begin to normalize.

Anticipation of mid-term elections in the back half of the year are likely to have an increasingly significant impact on equity markets, good or bad. However, in the past several mid-term election years, stocks have generally performed well in the weeks leading up to and months following the election. The Omicron variant spooked markets in November but markets seem to be becoming comfortable with this more mild strain with some suggesting this wave may be the beginning of the end of the pandemic.

There is a high probability the year ahead will be more volatile than last, which should come as no surprise given the relative lack of volatility in 2021. However, the earnings backdrop for corporations is still quite constructive. Equity market performance is likely to be more muted than the impressive returns in 2020 and 2021. However, we feel strongly long-term investors will be rewarded with an allocation to equities especially given the outlook for other asset classes.

Positives

Earnings momentum

COVID case count/hospitalization rate decoupling

New vaccine breakthroughs

Negatives

Supply chain and labor shortages

Unknowns

Transitory or persistent inflation

FIXED INCOME OUTLOOK

Summary

Yields across the entire Treasury curve ended the month higher with 10 and 20-year bonds increasing by about 7 basis points (bps) and 3, 5 and 30-year maturities increasing by 10 bps to 11 bps. Reflecting a more hawkish Fed policy, the 2-year note increased by nearly 17 bps. As such, treasury bonds of all maturity ranges delivered negative returns for the month. On the other hand, aggregate corporate bond spreads narrowed by 9 bps allowing intermediate-maturity corporate bonds to deliver a positive return for the month. The small gain was not enough to carry the broad indices to the plus side of the ledger.

For the Bloomberg Intermediate Government/Credit Index, the negative return for the month of December capped a year that saw intermediate maturity bonds deliver their first negative return since 2013. This was only the third decline experienced by this index in the past 30 years. The other yearly losses were way back in 1994. For the comparable index with bond maturities out to 30 years, this was the fifth negative return over that period with the additional losses in 2018 and 1999. As expressed in these indices, losses in the bond market are rare and have never occurred two years in a row. But the 10-year note has only started the year at a lower yield on one occasion, which was last year. So there is always opportunities for firsts.

At their December meeting, the Federal Reserve's Open Market Committee (FOMC) announced a widely anticipated acceleration in the pace of reductions in asset purchases. The faster tapering of purchases will allow the emergency, pandemic-related program to end in March as compared to the June date announced in November. The committee members also released their individual forecasts for the appropriate level of the Fed Funds overnight rate going forward. Their consensus now calls for three rate hikes this year, three more in 2023, and two additional in 2024. The broad inflationary pressures observed throughout the economy have caused the Fed to pivot dramatically from their March forecast of no rate hikes through 2023.

Monetary policy is a very blunt tool to address the causes for the inflation that we have all witnessed. Labor force contraction, energy prices, shipping and transportation bottlenecks and massive fiscal stimulus have been much more the source than the overnight lending rate. We believe the Fed needs to focus on reducing their balance sheet that is approaching \$9 trillion and take a more cautious approach to the overnight rate increases. Hikes will happen this year and into 2023 but we will be surprised if they can reach the levels they forecast. Short rates are appropriately priced for these increases and longer rates will likely make the push modestly higher that we have been hoping to see.

Positives

Short maturity yields reflect aggressive Fed rate policy

Inflation should peak in the first half of 2022

Negatives

Possibility of additional massive Federal spending

Technical levels could fuel a push higher in yields

Unknowns

Ability to correct trade and transportation bottlenecks