Q4 2021
Investment Perspectives

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- **OMICRON UNCERTAINTY:** With the Omicron variant of COVID-19 rapidly spreading, investors grappled with the specter of renewed restrictions, enduring supply chain issues, and labor shortages. Early signs were that Omicron is more contagious but less severe than prior variants, offering hope that this could finally mark the shift from pandemic to endemic.
- **HIKES ON THE HORIZON:** After announcing intentions to accelerate the tapering of its bond purchasing program, the Fed communicated plans to hike interest rates more quickly than anticipated in 2022 as inflation readings surged and the unemployment rate sank. Short-term rates moved higher in response, but longer-term yields remained stuck in a relatively narrow trading range during the second half of the year.
- **SAME OL' SAME OL':** Despite relative strength early in the year from small caps, value stocks and non-US indices, 2021 ended with a familiar scoreboard for investors – large caps, growth stocks, and the US reprised their roles as market leaders.

Market Recap

Risk assets were broadly positive in Q4, and most major equity markets finished the year with heady gains. US stocks led the advance once again despite the emergence of a new COVID variant, increasingly hawkish rhetoric from the Fed, as well as stubbornly elevated inflation readings. Outside of the US, returns were more muted in developed market equities, and emerging markets capped an underwhelming year with consecutive negative quarters. EM sentiment continued to be weighed down by China's regulatory crackdown and efforts to rein in economic imbalances from extreme risk taking—particularly in the real estate sector.

After trailing the Russell 2000 early in the year, the S&P 500 rallied back into its familiar role of market leader by year end. Its 11.0% advance in Q4 extended the large cap benchmark's annual gains to 28.7%, which ranks as the fourth best year out of the last 25. Small cap stocks remained stuck in a relatively narrow trading range and the Russell 2000 was unable to sustain any attempts at breaking out to all-time highs. The large/small relative

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FIXED INCOME

	USD Total Return (%)	
Index	**Q4**	**YTD**
Barclays 1-10 Yr Muni	0.2%	0.5%
Barclays US Agg. Bond	0.0%	-1.5%
BofA/ML HY Master II	0.7%	5.4%

EQUITIES

	USD Total Return (%)	
Index	**Q4**	**YTD**
Russell 3000	9.3%	25.7%
S&P 500	11.0%	28.7%
Russell 2000	2.1%	14.8%
MSCI All Country World	6.7%	18.5%
MSCI EAFE	2.7%	11.3%
MSCI Emerging Mkts	-1.3%	-2.5%

Source: Bloomberg (Data as of 12/31/2021) performance dynamic mirrored the growth/value trajectory in 2021; value started strong but barely managed to make new highs after Q2, whereas growth surged higher in Q4 and closed 2021 near all-time highs.

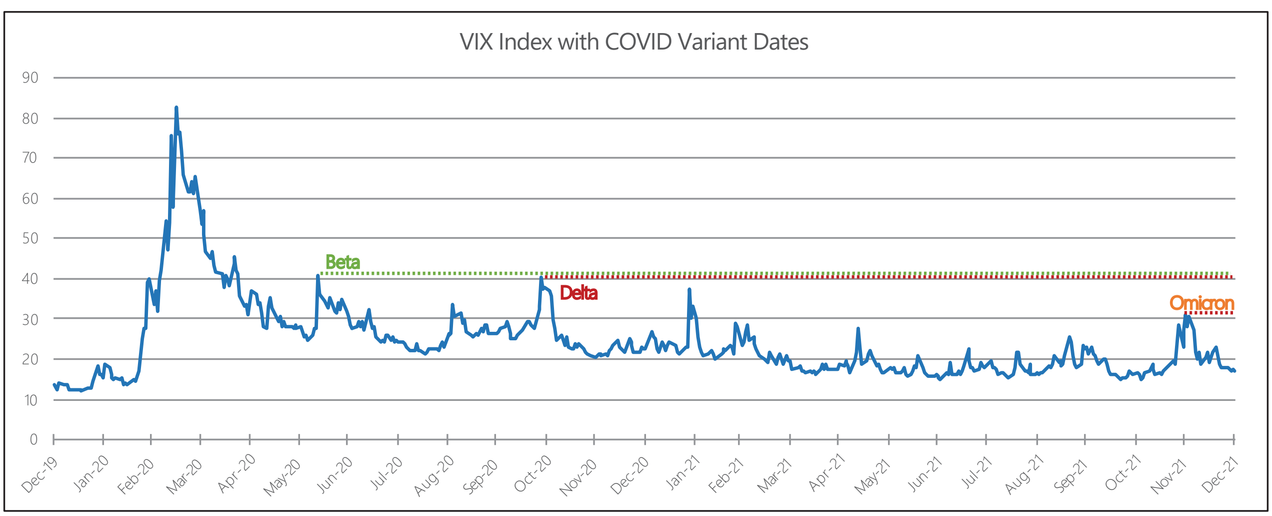
For the tenth year out of the last twelve, non-US stocks lagged their US counterparts—as measured by the MSCI All Country World ex. USA and Russell 3000 returns. The uneven global economic recovery and a weakening growth impulse from China continued to weigh on non-US equities, and the general tilt toward cyclical sectors has continued to make them vulnerable to underperformance outside of robust economic expansions. Within the non-US complex, emerging markets' returns lagged again as China's political leadership remained steadfast in its desire to curb speculative excesses and implement social reforms under the driving theme of "common prosperity". The MSCI China Index finished with a -21.7% return for the year, and China's massive weight in the MSCI EM Index led to a 2.5% decline for the EM benchmark in 2021.

On the fixed income side of the ledger, despite trading as high as 1.7% and as low as 1.3% during the quarter, the 10-year Treasury yield closed Q4 virtually unchanged at 1.5%. This came against a backdrop of higher inflation readings, with November's Consumer Price Index (CPI) print showing a 6.8% year-over-year increase—the highest level since 1982. Moreover, Fed Chair Jerome Powell confirmed the central bank's intentions of tapering its asset purchase program more quickly than previously planned, and meeting minutes from the FOMC's December meeting showed an increased likelihood of multiple interest rate hikes in 2022. The Barclays Aggregate Bond Index took the news in stride, finishing flat for the quarter, but rising yields in Q1 underpinned the index's -1.5% return for the year.

Credit markets ended 2021 on a positive note as investors continued to search for yield and remained sanguine about the prospects for corporate health. The BofA/ML High Yield Index posted a 0.7% gain for the quarter, bringing its annual return to 5.4%. Credit spreads—or the excess yield that investors demand for holding riskier debt relative to Treasuries—closed the year near multi-year lows and within reach of their all-time low levels.

VARIANT VOLATILITY

The fourth quarter saw the emergence of yet another COVID variant of concern, Omicron. Early fears about Omicron's rapid spread moderated somewhat as data began to suggest that it would be much less severe than the previously dominant Delta variant. From the market's perspective, anxiety dissipated quickly. Consider the chart below that shows the Cboe VIX Index—a measure of how much volatility investors are expecting from the S&P 500 over the next 30 days. More colloquially, the VIX is also known as the "fear index", and generally spikes higher during periods of market turbulence and uncertainty. The initial COVID outbreak in Q1 2020 is unmistakable on the chart; the VIX jumped to its highest level since the global financial crisis as markets were experiencing swings of 5% or more some days. The subsequent variants noted on the chart caused their own episodes of volatility after being identified, but each peaked at a lower level before the VIX resumed its broader downtrend.



Source: Bloomberg (Data as of 12/31/2021)

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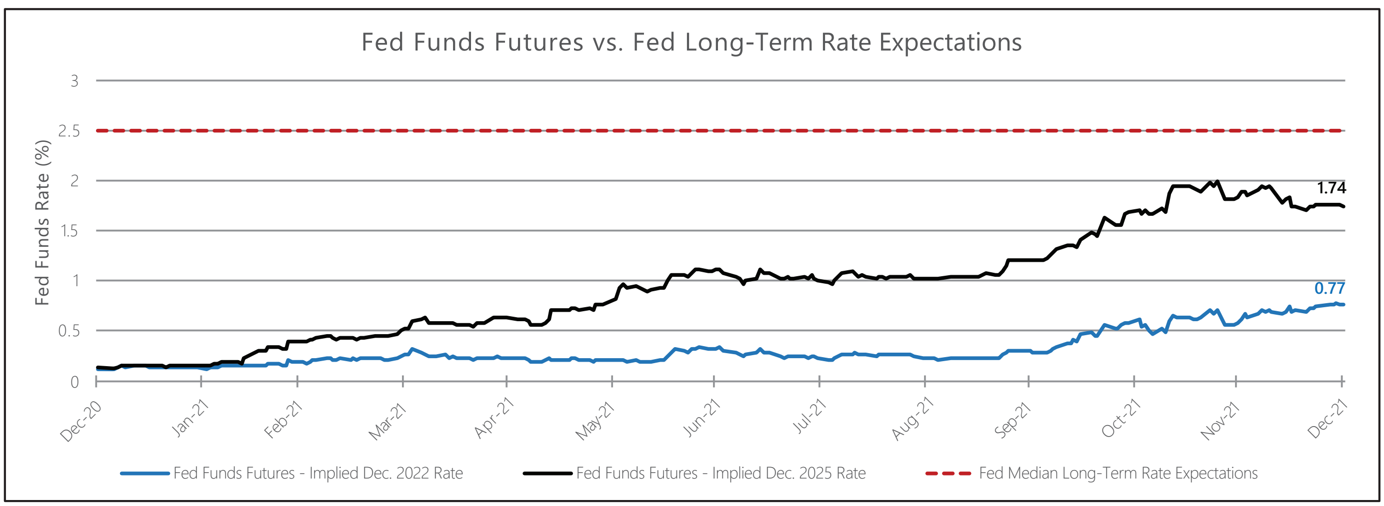
While we by no means want to diminish the ongoing healthcare implications, the takeaways for markets and the economy appear clear. For one, investors' reaction function is becoming increasingly muted. The knee-jerk "sell first, ask questions later" mentality has evolved into a more discerning approach as evidenced by the lower spikes in volatility. Second and perhaps most importantly, there is optimism that Omicron could represent the transition of COVID from pandemic to endemic. Because it is so highly contagious—even among vaccinated persons—it appears increasingly likely that herd immunity will finally be achieved. Add in the approval of effective therapeutics, and there were reasons to be optimistic about the trajectory of COVID.

POWELL PUTS MARKETS ON NOTICE

As Omicron caused a COVID spike in Q4, headline inflation readings also spiked to levels not seen since the 1980s. Federal Reserve Chairman Jerome Powell and his colleagues finally delivered the about-face that many investors had been calling for, acknowledging that predictions of a "transitory" bout of higher inflation were incorrect. More broadly, it was becoming increasingly clear that the Fed was already behind the curve; not only was inflation running hot, but the headline unemployment rate was approaching 4% and the cost of capital was not an impediment for economic activity.

In light of the Fed's revised guidance, markets began to rapidly adjust their expectations. The chart below shows this trajectory by looking at Fed Funds futures—representing the market's best guess at what Fed policy will be at a given point in time—for the end of 2022 in blue. After barely pricing in a single 25 basis point increase through Q3, expectations jumped to reflect three hikes by the end of the year.



Source: Bloomberg (Data as of 12/31/2021)

Despite the clear shift in Fed rhetoric and the upward revisions for rate expectations in the near term, longer-term expectations suggested that the market remained confident in the Fed's ability to control inflation and doubtful that they could hike rates meaningfully higher without damaging the economy. Specifically, the black line on the chart above shows the market's expectations for the Fed's policy rate at the end of 2025—effectively investors' best guess at where this rate hike cycle would peak. After getting as high as 2%, the long-term pricing closed the year at roughly 1.7%, suggesting a "faster but fewer" approach for the Fed this cycle. Contrasted with the dashed red line at 2.5%—the Fed's published assumptions about the long-term level for rates—investors are clearly viewing the Fed's guidance with a healthy dose of skepticism this cycle.

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BUILD BACK BETTER BREAKDOWN

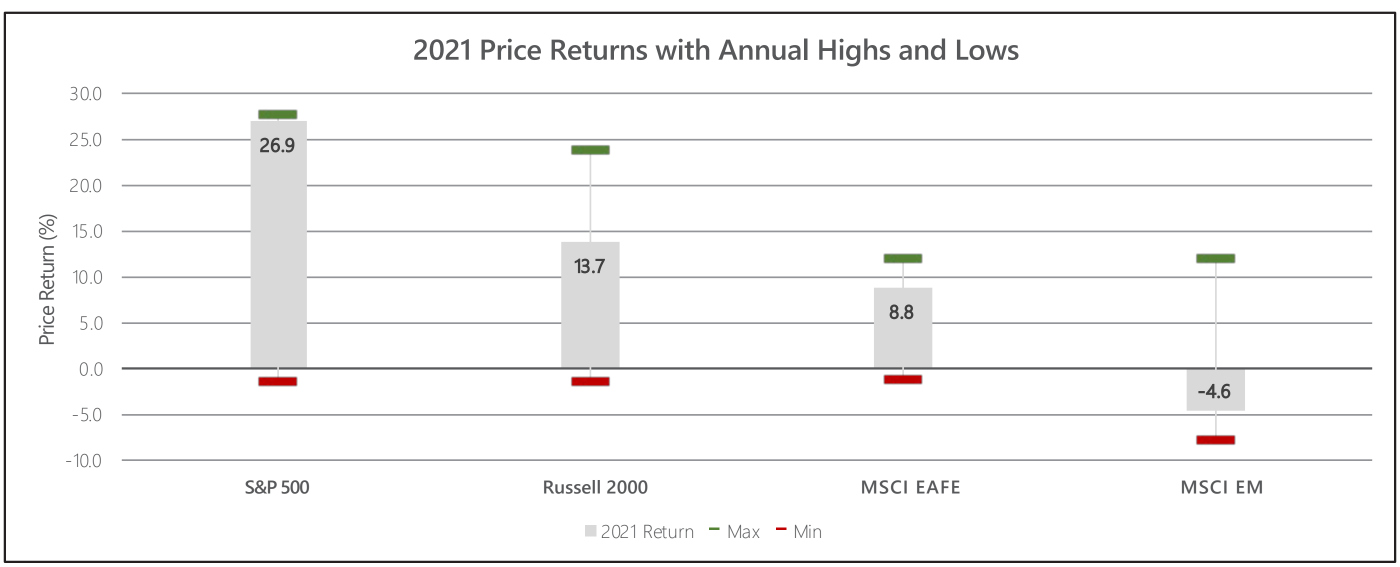
After months of discussions about the multi-trillion dollar "Build Back Better" budget reconciliation bill that was set to expand the social safety net, spend billions on green energy initiatives, and raise taxes, Democrats' legislative hopes were dealt a significant blow as West Virginia Senator Joe Manchin publicly withdrew his support for the bill. Manchin offered a framework for a reduced package, but the general consensus is that the bill will have a steeply uphill climb toward passage in an election year—particularly if Democrats begin shifting their focus to voting rights legislation.

Without arguing the merits of the bill itself, the clear question for investors is whether a slimmer US budget in 2022 will have an impact on the economy and/or markets. Based on the current estimates from the Congressional Budget Office, the budget reduction from 2021 to 2022 would represent the largest fiscal cliff since World War II. As it currently stands, government outlays would decline from approximately $6.8 trillion in 2021 to $5.5 trillion in 2022, representing a spending reduction of nearly 20%, or a decrease of roughly 6.5% of GDP.

To be sure, the absolute levels of spending remain staggering in a historical context. How much the markets choose to focus instead on the rate of change remains to be seen, but it is worth noting that the last time we saw a spending reduction of this magnitude was from 1946 to 1948. Over those three years, the budget shrank 40%, 38%, and 14% on a year-over-year basis. The S&P 500 price return in those years? -12%, 0%, and -1%, respectively. Investors should take those figures with a large grain of salt given the apples-to-oranges comparison between markets then and now, but perhaps it offers some cautionary guideposts to consider if the Democrats' flagship legislation fails to materialize.

ONE OF THESE THINGS IS NOT LIKE THE OTHER

One of the consensus views coming into 2021 was that the rollout of vaccines and accompanying economic re-opening would catalyze relative returns for beaten up segments of the market. Small caps and non-US stocks were at the top of many prognosticators lists for good reason: relative valuations were attractive versus US large caps and looked ripe for a mean reversion in a more favorable macro environment. However, as the year unfolded, US large cap stocks once again outperformed other major markets. Notably, as illustrated on the chart below showing the annual price returns as well as the high and low water marks, other markets closed the year meaningfully off their highs, while the S&P 500 showed strength into year-end.



Source: Bloomberg (Data as of 12/31/2021)

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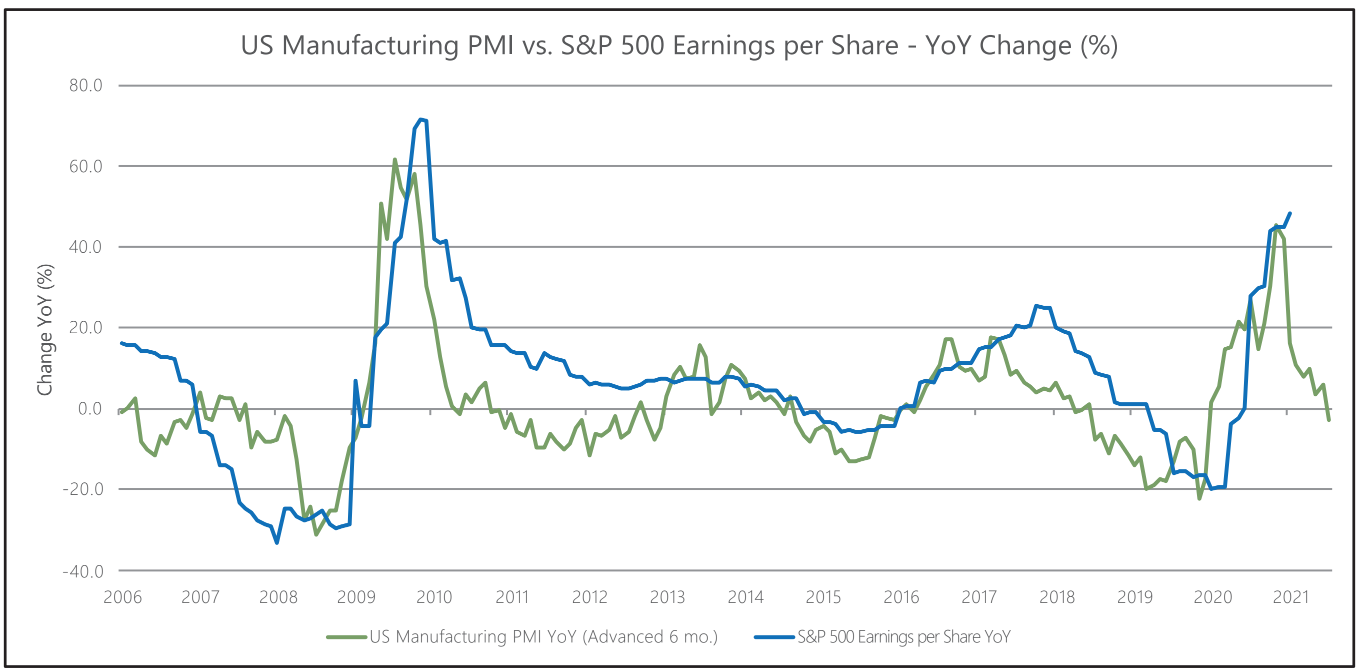
Clearly, EM stocks have been dealing with their own set of idiosyncratic issues, most notably manifesting itself via weakness in Chinese markets. European and Japanese markets had troubles navigating COVID and the uneven global economic recovery. US small caps faltered as US growth expectations slowed and interest rates stopped rising. History would suggest that the persistent, lopsided outperformance from US large caps will eventually come to an end, but 2021's results reinforced the old market adage: "The trend is your friend". ●

2022: Less of the Same?

As discussed in prior sections, 2022 is poised to usher in a wave of changing macro fundamentals relative to 2020 and 2021 with varying implications for investors. The world would happily welcome a return to normalcy as it relates to COVID protocols, travel, etc., but the concomitant normalization in financial markets may not be as warmly embraced. Below, we highlight three key dynamics that investors should watch closely in the new year.

1) **TIGHTER MONETARY CONDITIONS.** With the Fed tapering its quantitative easing programs aimed at supporting the Treasury and mortgage markets, the central bank's balance sheet will stop expanding in 2022 and may ultimately start contracting for the first time since 2018. Moreover, with the Fed suggesting that it will hike rates three times in 2022, measures of financial conditions will begin to reflect a much less supportive monetary backdrop.

2) **GROWTH DECELERATION.** After roughly 18 months of economic recovery fueled by monetary and fiscal largesse, economic growth is likely to decelerate toward its longer-term trend in 2022. Bloomberg consensus estimates expect GDP growth of 3.9% for 2022, down from just under 6.0% in 2021. The chart below shows a key gauge of US manufacturing health—the Institute for Supply Management's Purchasing Managers' Index—on a year-over-year basis versus the S&P 500's earnings per share. The PMI data is advanced by six months and suggests that corporate earnings growth will also be coming off the boil.



Source: Bloomberg (Data as of 12/31/2021)

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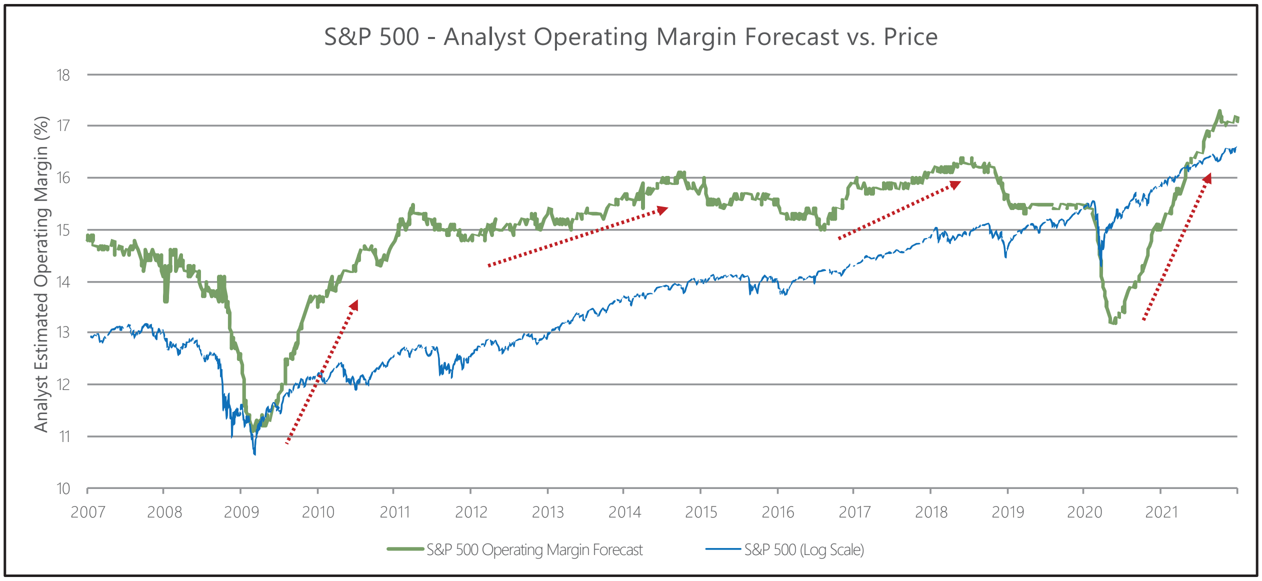
3) **ALL-TIME HIGH MARGINS**. After an extraordinary run for corporate margins off their pandemic lows, analysts see less scope for margin expansion in 2022. The chart below shows analyst estimates for S&P 500 operating margins in green, overlaid against the S&P 500 Index level in blue over the last 15 years. With price and wage pressures building alongside the likelihood of higher interest rates, it is reasonable to wonder if margins can sustain these lofty levels—comfortably above their peak in the prior cycle. For investors, it is clear that the most fruitful periods for the S&P 500 have been when margins are expanding (red arrows), so a consolidation phase may be in the offing.



Source: Bloomberg (Data as of 12/31/2021)

These dynamics are by no means a death knell for risk assets, but it seems increasingly likely that 2022 will see a handoff from liquidity-driven markets to fundamentals-driven markets. Investors should prepare for bouts of volatility as markets reposition amid an evolving macro regime. ●

Chart of the Quarter

With the Fed preparing to embark on an interest rate hiking cycle—likely in the first half of 2022—investors are rightly wondering how much scope the central bank has to increase its benchmark policy rate before it begins to choke off economic growth. Economists have numerous, granular ways to measure the degree to which monetary policy is accommodative or restrictive, but sometimes a more intuitive approach can provide helpful context.

The Q4 Chart of the Quarter on the following page takes a long-term view of the Fed Funds target rate, going back to its inception in 1971. The green line shows the trajectory of Fed policy, ebbing and flowing through economic cycles and inflation regimes—perhaps most notably and apropos of the current environment, when Fed Chair Paul Volcker oversaw dramatic interest rate hikes in the early 1980s to combat elevated consumer prices. The nuance is that we are using the so-called Fed Funds "shadow rate" for periods after the global financial crisis. The shadow rate provides an estimate of the effective policy rate when accounting for the Fed's quantitative easing measures and can dip into negative territory. In other words, even though the Fed has not explicitly taken rates below zero, their QE programs have had an equivalent effect. Additionally, the red shaded areas represent US recessions on the chart, and we added a simple "best fit" line (dotted blue) that shows the trajectory of rates over this 50-year period.

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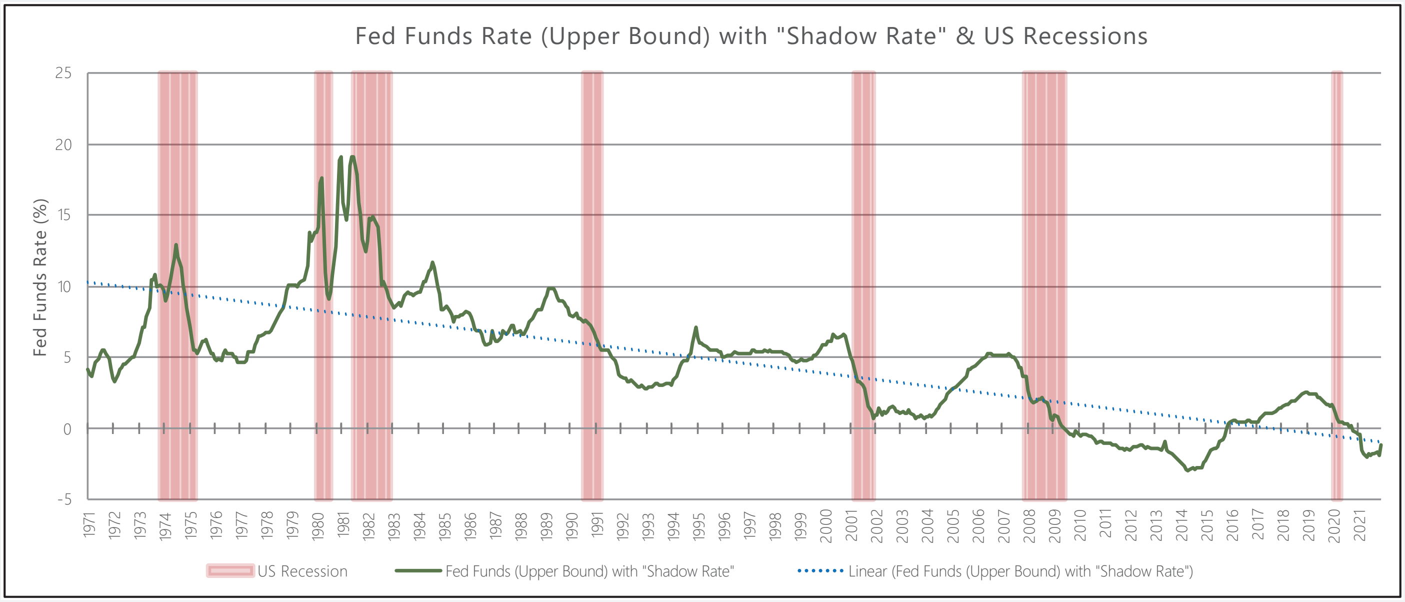

Source: Bloomberg (Data as of 12/31/2021)

The implications of this chart are numerous. For one, the trend for the Fed Funds rate is decidedly lower over time. Each successive hiking cycle after the early 1980s has seen a lower peak for Fed Funds before the economy entered a recession. This is partly a function of the structural evolution of the economy and demographics, but it also speaks directly to the extraordinary accumulation of debt in recent decades. As interest rates rise, debt costs more to service. The Fed has stopped short of causing a catastrophic—if cathartic—default cycle and has arguably been the greatest enabler of the growing indebtedness by keeping rates low. To think that leadership would have the political will to pursue a different tact this cycle would be ignoring roughly 40 years of empirical evidence. Hence, the concept of the "Fed put", or the idea that the central bank will backstop markets when they experience some degree of losses, remains alive and well.

Second, the recessionary periods on the chart have typically occurred after the Fed Funds rate is 2-3% above the long-term trendline. With the trendline now around -1%, that would seem to suggest that the Fed could hike rates to somewhere between 1% and 2%—after unwinding their QE program and taking the shadow rate out of negative territory—before impairing the economy. This would be consistent with the "lower peaks" comment in the prior paragraph; the most recent Fed hiking cycle topped out at 2.5% in 2019. This would also jibe with the market's skepticism that the Fed can achieve its stated long-term target rate this cycle, as evidenced by Fed Funds futures pricing.

For investors, the simple rule of thumb is that stocks tend to outperform bonds unless the economy is entering a recessionary period. Volatility may trend higher as investors digest the rising rate environment and rotate their underlying exposures, but this analysis would suggest that we are a number of rate hikes away from the true "risk off" tipping point. ●

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