Investment Update

Fourth Quarter 2021

Widening our lens to the entire year, 2021 was the third consecutive year of double digit returns for the S&P 500, with 2019 and 2021's both better than 25%. Small and mid-sized US companies' shares followed close behind, and all were notably ahead of the broad indices of foreign companies' shares. The underperformance of emerging markets was particularly stark, and mostly attributable to an even worse performance by Chinese companies which constitute about a third of the index. This overall pattern of relative returns repeated itself in the fourth quarter.

Equity Markets (Total Return)	4Q'21	1-Year
Dow Jones Industrials	7.9%	20.9%
S&P 500	11.0%	28.7%
S&P Mid-Cap	8.0%	24.8%
S&P Small-Cap	5.6%	26.8%
MSCI All-Country World	6.8%	19.0%
MSCI Foreign Developed Markets	2.7%	11.8%
MSCI Foreign Emerging Markets	-1.2%	-2.2%
US Bond Markets (Total Return)	**4Q'21**	**1-Year**
Bloomberg US Treasury	0.2%	-2.3%
Bloomberg US Municipal	0.7%	1.5%
Bloomberg US Corporate Investment Grade	0.2%	-1.0%

The 10-year Treasury yield ran up from about 1% to 1.75% in the first quarter, subsequently fell back to 1.2% by mid-summer, and bounced around 1.5% throughout the fourth quarter despite accelerating inflation. Economic growth slowed over the summer with the emergence of the virulent Delta variant, but the overall arc of positive earnings news and progress against the Covid-19 virus was reflected in stocks' persistent rise over the course of the year.

The largest US stock market pullback was a modest decline of about 5% during September and early October, though stocks quickly made up that lost ground in October and proceeded to a succession of new all-time highs. The question of when the Fed would take the first step in reducing its long-time accommodations by starting to shrink its balance sheet has been the subject of much investor interest throughout the year. When a schedule for tapering its bond purchases over several months was announced in early November, bond yields ironically fell (prices rise when yields fall) despite the implicit reduction in future demand.

Then news of the Omicron variant hit late in a quiet, Thanksgiving-shortened trading week. This set equity investors up for a choppy remainder of the trading year as the world grappled with the exact nature of the variant and what effect it might have on economic activity (as well as how to actually pronounce Omicron). However, with another inflation reading above 5% and other signs of economic strength, the Fed was compelled to increase the planned pace of tapering by December. That news, along with changes to the Fed governors' "dot plot" predictions of future rates, caused market-based expectations for Fed rate hikes during 2022 to go from zero to three.

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Ultimately the fourth quarter ended on a high note with equities back to setting all-time highs, as the balance of evidence suggested the virus is taking a typical path of morphing in to being more contagious and at the same time becoming less dangerous. There is no guarantee of this trend continuing, so we expect investors will be spooked when new variants emerge, at least until the specifics become clear and each spike subsides. Sadly, there is a human toll to all of this as local mask mandates, case counts, and hospitalizations are rapidly on the rise as we write this piece. However, with such a broad base of vaccinated and "boosted" individuals it seems unlikely the economy will face the sort of widespread, growth-halting lockdowns of 2020.

A year ago it was widely expected that inflation readings were about to become eye-catching, simply because year-over-year comparisons would start to be made with the depths of the 2020 recession when general pricing levels actually fell. However, as 2021 progressed, the confluence of stronger than expected consumer demand, and lingering supply chain issues have made for a real inflationary trend that is likely to last a while longer in 2022. Traditional monetary policy can only suppress overheating demand, not inflation resulting from constrained supply. As discussed last quarter, the global supply chain is snarled for a variety of reasons, many of which are covid-related, and most of which lack easy solutions or clear timelines for resolution. Although the term was never meant to mean "gone in a month or two," the Fed has stopped trying to call elevated inflation transitory. With the yield available on long-term Treasuries several percentage points below current inflation readings, investors are largely signaling their belief that inflationary pressures will recede before too long.

On the assumption that Covid-19 continues its current trajectory from frightening pandemic to endemic nuisance, we see many reasons to continue to stay positive about US equities. Compared to other readily investable asset classes, stocks have had the best record of providing inflation-adjusted returns over the longer-term, even if they do not necessarily out-earn inflation in specific periods of very high inflation. The Fed has started on a path toward less accommodative policies, but we are inclined to see its telegraphed course of action as an appropriate return to normal policy rather than an overreaction that might put true downward pressure on the economy and risk triggering a recession. Thus the current expansionary environment should allow for another year of strong earnings growth across the entire economy. In addition, our stock market has the largest concentration of innovative technology companies with highly profitable business that continue to expand and diversify.

Stocks' valuations have gotten cheaper over the course of the last year as earnings have risen more quickly than prices, but valuations are still high now in comparison to the past few decades. It is reasonable to expect that future returns might be lower when stocks start out at relatively high valuations, so our constructive stance on equities comes with a caution that we are unlikely to see another 10 years of double-digit annual returns like we have just experienced.

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