QUARTERLY MARKET UPDATE

JANUARY 2022

MARKET LANDSCAPE

Name	2021 Returns
Barclays US Aggregate Bond	-1.5
Barclays US Credit	-1.1
S&P 500 TR USD	28.7
Barclays US Corporate High Yield	5.3
MSCI Emerging Markets	-2.5
MSCI EAFE	11.3
Russell 2000 TR USD	14.8

Data Source: Morningstar Direct

2021 in Review

2021 was a remarkable year and proved very beneficial to global stocks. In the US, the combination of government fiscal and monetary support, coupled with a recovering economy, an improved employment picture, pent-up consumer demand, and ultimately strong corporate profitability was a potent mixture supportive of markets.

The Standard and Poor's (S&P) 500 index returned 28.7% last year. The dominant US market-proxy index, heavily weighted towards a handful of stocks such as Microsoft (MSFT), Meta Platforms (FB), Alphabet (GOOG), Apple (AAPL) etc. outperformed most other global large-cap stock indexes. This cohort of companies has provided outsized returns over the past number of years, given their dominant market share and profitability, and their shares have been purchased and held by institutional and retail investors alike.

The retail investor class asserted itself as a major factor in markets as meme stock investing became frontpage news. These trading behaviors were influenced by aggregate investor emotion much more than underlying fundamentals.

Risk-on attitudes led to significant corporate debt issuance, numerous mergers and acquisitions, increased company initial public offerings, and the creation of special purpose acquisition companies. Nascent but potentially promising industries in blockchain/digital assets, electric vehicles etc. gained outsized attention as investors searched for areas of opportunity beyond traditional sectors.

Speculation was aided and amplified in 2021 by The Federal Reserve's (Fed) accommodative monetary policies, which have dictated persistently low interest rates. This loose monetary policy, in conjunction with very supportive government fiscal policy (economic impact payments, infrastructure bill) further enhanced this investor behavior.

However, these factors contributing to strong earnings results, in conjunction with an economy still dealing with many operational inefficiencies, have created higher than desired levels of inflation. The annual inflation rate in the US climbed to 6.8% in November of 2021, the highest in almost 40 years.

Inflation remains persistently above the Fed's articulated 2% target. Initially, the Fed was insistent that this was a "transitory" phenomenon but has since backed away from that assessment and is telegraphing a more aggressive policy posture.

This change in attitude has recently dampened investor enthusiasm for some of the more highly valued, less profitable growth stocks, though the broader market indexes still demonstrated strength as 2021 concluded.

Sector Returns

S&P 500 Sectors	2021 Returns
Information Technology	34.5
Consumer Discretionary	24.4
Communication Services	21.6
Health Care	26.1
S&P 500	28.7
Consumer Staples	18.6
Materials	27.3
Real Estate	46.2
Utilities	17.7
Industrials	21.1
Financials	35.0
Energy	54.6

Data Source: Morningstar Direct

The Fed Pivots

With inflation at the forefront, it's no surprise that investors are paying close attention to The Federal Reserve's forecasts and language regarding its future actions. The Fed operates under a mandate from Congress to "promote effectively the goals of

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maximum employment, stable prices, and moderate long term interest rates"; what is now commonly referred to as the Fed's "dual mandate."

The idea that the Fed should pursue multiple goals has long been held, though at times creating tension as to which mandate to favor. The prospect of rising inflation related to fiscal and monetary events over the past year and a half has been ignored in favor of repairing employment conditions.

These efforts have largely been successful. One can argue that the US economy is approaching maximum employment, with the current unemployment rate sitting at 4.2%. Strong job creation has been a primary pillar of the economic recovery and is vital for continued growth in conditions defined by inflation and supply shortages.

However, the labor market is still comprised of almost 4 million fewer jobs then in February of 2020, and only approximately 59% of the population is employed compared to 61% in pre-pandemic levels. The pandemic has ushered in what is being termed "the great resignation" as people leave the workforce causing labor shortages across different industries, with mismatches in skillsets and geography.

These labor shortages are inflationary. By restricting labor supply, upward price pressure on wages ensues. These increases are passed on to the consumer in the form of higher costs for goods and services, and simultaneously strengthens demand from consumers resulting from higher wages.

Thus, the labor force recovery is not as robust as perceived or desired, and it seems the Fed is not confident this will change quickly. So, it looks as though rate hikes are imminent. The Fed recently doubled its pace of asset purchase tapering so that net purchases will conclude at the end of the first quarter. This establishes the March 2022 Federal Open Market Committee (FOMC) meeting as the first real possibility of an interest rate increase.

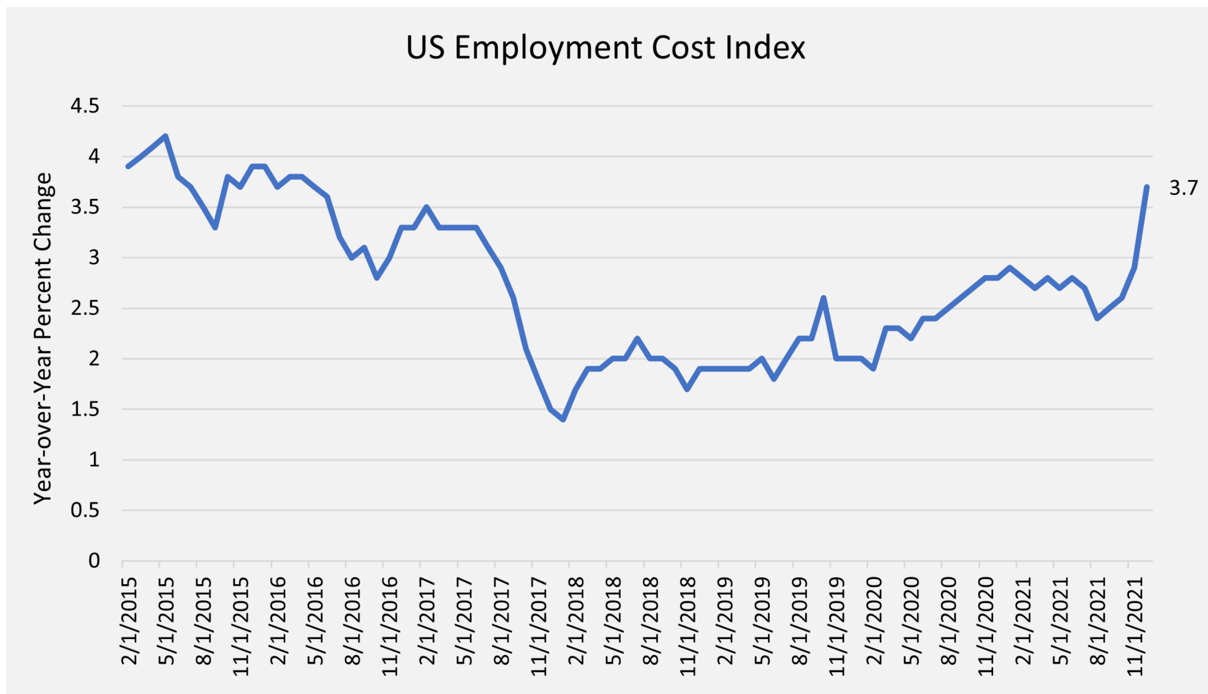
Industry consensus is that the Fed will wait longer, though, where the June meeting will initiate the first increases. Rate hikes will then proceed through the end of the year at a pace of 25 basis points per quarter, for a total of three in 2022.

How Will Markets React?

Investors understand tighter monetary conditions are on the horizon. What that means for capital markets and risk assets (in terms of investor behavior) generally is unknown, though it's fair to conclude that the more aggressive the Fed becomes in its actions and timing, the more volatile markets will become.

The Fed finds itself in somewhat of a tough spot, balancing inflation

Chart 1 - Employment Cost



Source: US Bureau of Labor Statistics via YCharts

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fears and economic growth fears simultaneously. This is a unique and unenviable situation, as growth and inflation are generally positively correlated; that is, inflation results from overheated (too much) growth.

By raising interest rates to curb inflation, economic growth (and by extension, capital markets and risk assets) will also be impacted. The Fed will need to walk a very narrow path in accomplishing this feat. Success will be predicated on accurate and timely communication regarding its intentions.

Even with the prospect of markets becoming volatile, though, markets can exhibit overall stability in the face of interest rate increases if broad economic fundamentals prove sufficiently supportive.

As we've seen in the past, the first fed hike in a cycle has often resulted in a mild, short-term sell-off in equities, but stability and upward movements resumed in the face of additional rate increases. This dynamic was seen in the last rate tightening cycle beginning in 2015.

Inflation Conditions to Ease

Though inflation is in our view largely a function of money supply, normal supply and demand factors play an important role. Pent-up consumer demand resulting from the post-pandemic economic recovery and supply chain imbalances across the global economy have both been impactful to the inflation picture recently.

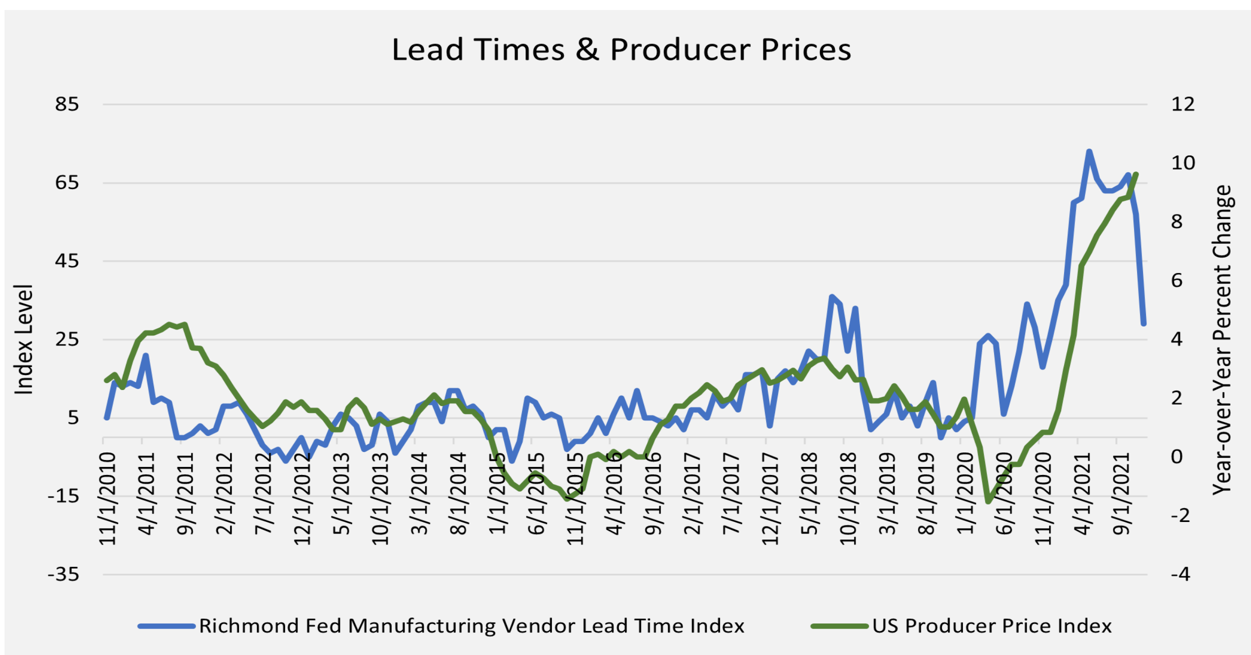
There's no question that what we are witnessing is the result of elevated consumer interest for manufactured goods, while vendors are unable to produce the goods and services commensurate to demand, ultimately causing shortages.

The question has always been, how long and to what degree will both elevated demand and shortages from supply chain disruptions remain?

We believe that consumer demand should stay strong in 2022. The economic backdrop signifies strength, augmented by robust consumer spending of accumulated savings and an elevated wealth effect from multiyear asset price inflation.

Regarding supply, we believe the economic imbalances plaguing supply chains have already improved and will continue to in the months and years ahead. Chart 2 demonstrates the significant improvement in vendor lead times over the past quarter. A continuation of this trend will be positively impactful to inflation statistics in the near term.

Chart 2 - Vendor Lead Times Decreasing



Source: Federal Reserve Bank of Richmond via YCharts

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We do not anticipate lower inflation in an absolute sense over the next number of years. The significant expansion of the monetary base over the past two years all but ensures higher price levels for goods and services in the future as compared to pre-pandemic levels. However, the rate of change from current levels should abate. The consensus average forecast of core personal consumption expenditures (PCE) inflation, the Fed's preferred measure, is 3.3% in 2022.

International Appeal

As previously indicated, US stocks finished another strong year with major indexes near records at year end 2021. According to JP Morgan, in this past year the percent increase in the S&P 500 index attributable to corporate earnings growth was 34.5%, while price-to-earnings (P/E) multiple compression contributed a negative 7.6% (totaling 28.7%). This highlights the strength of economic conditions present post- pandemic.

Superior real returns (the rate of return less inflation, which is important to maintain purchasing power) have been easy over the past number of years. Going forward, though, deceleration in earnings growth and margin contraction may occur if there is a slowdown in top-line growth, a decline in corporate pricing power, or increases in labor and input costs.

And while corporate earnings and revenue growth are expected to be strong this year (9.2% and 7.5%, respectively) year-over-year comparisons will look underwhelming given the high bar set last year. Price levels in combination with earnings growth projections indicate that US markets are at least fully valued. This does not stipulate a decline in US stocks; valuation is a poor predictor of near-term returns.

Currently though, US stocks are trading at a significant premium to non-US developed world stocks, which have lagged their US counterparts over the past decade. Macro fundamentals combined with relative valuations may alter that dynamic this year.

The current price-to-earnings discount of international stocks versus domestic stocks sits at historical lows. Comparing the P/E of the MSCI All Country World Index (ACWI) ex-US to the S&P 500, it registers almost three standard deviations below its historical average; as of December 31st, 2021, the P/E of the ACWI is 32.7% lower than the S&P 500.

Additionally, we believe international stocks tend to show strength when global growth outpaces trend, which is the expectation for 2022. International sector exposure provides greater cyclical coverage which is consistent with our bias towards quality and value factors, as value outperformance tends to coincide with periods of rising rates.

While conditions in 2022 may prove more challenging than last year, we remain constructive on equities, as the economic backdrop and corporate profitability still provide support. While growth and earnings expectations are lower than last year, they remain above historical trends. Inflation, Federal Reserve policy, and valuations will combine to reduce return expectations compared to previous years. Nevertheless, investors aligning their expectations to this reality will not be surprised by volatility and likely be rewarded with adequate prospective outcomes.

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by BerganKDV

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