Market Commentary

Candyland

4Q, 2021

Summary

- Equity markets delivered positive returns in the final quarter while fixed income returns were flat.
- Due to an improving labor market and stubbornly high inflation levels, policymakers are set to reduce the unprecedented fiscal stimulus and unsustainable levels of monetary policy accommodation.
- Inflation became officially politicized when Democratic Senator Joe Manchin of West Virginia cited it as the main reason for not supporting the Build Back Better fiscal bill.
- The tightening of monetary policy and reduced fiscal stimulus in 2022 will create more volatility across markets and the economy.

Overview

The last quarter of 2021 yielded mostly positive returns for equities and flat returns for fixed income securities. The S&P 500 gained 11.0% while the Bloomberg U.S. Aggregate Bond Index was flat. Markets were helped by delightful amounts of fiscal spending that contributed to an almost $1.2 trillion expansion in the U.S. public debt in the fourth quarter alone.[1] This deficit spending was partially funded by the $309 billion expansion in the Federal Reserve's balance sheet for the quarter and multiples of that for the year.[2] In 2021, the S&P 500 returned a stellar 28.7%. Equally as impressive was the fact that the largest drawdown for the index was just 4%, the sixth shallowest decline since 1968. The Bloomberg U.S. Aggregate Bond Index's flat return for the quarter kept year-to-date losses to 1.5%. This was the third-worst year since the index's inception in 1975, with the worst year being 1994 when the index returned -2.9%. That year, the 10-year Treasury yield rose from 5.8% to 7.8%. In 2021, the 10-year Treasury yield rose from a paltry 0.93% to a slightly less paltry 1.52%. The Bloomberg Commodity Index declined 1.6%, leaving the asset class up 27.1% in 2021 as prices gained from stimulus-fueled hyperactivity in parts of the economy and Covid-related supply-chain bottlenecks in others. 2021 was the second-best year for commodities since 1980.

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But all sugar highs eventually end. Two notable post-Thanksgiving developments stemmed from policymakers' desire to shift the economic backdrop as we head into 2022. First, Democratic Senator Joe Manchin of West Virginia cited inflation concerns as the main reason for not supporting the roughly $2 trillion Build Back Better legislation:

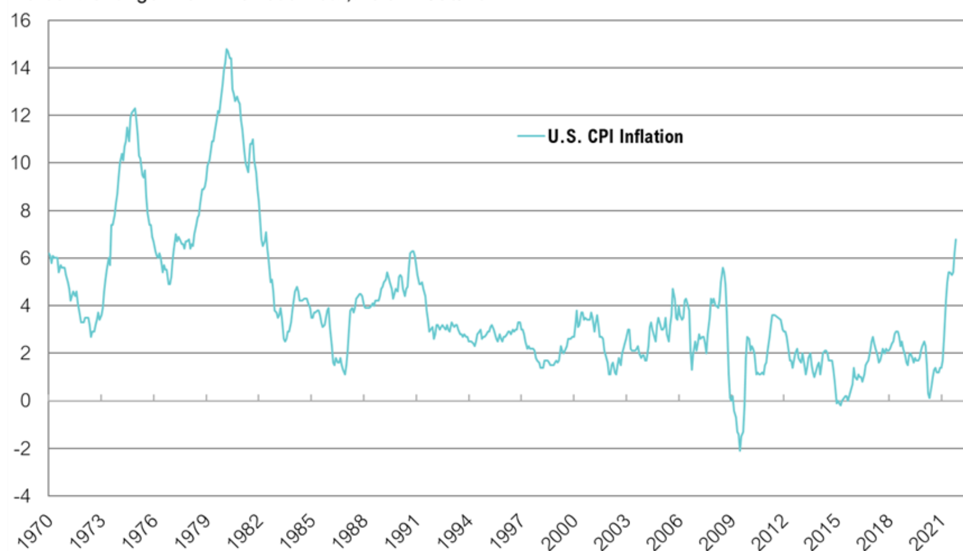
> "My Democratic colleagues in Washington are determined to dramatically reshape our society in a way that leaves our country even more vulnerable to the threats we face. I cannot take that risk with a staggering debt of more than $29 trillion and inflation taxes that are real and harmful to every hard-working American at the gasoline pumps, grocery stores and utility bills with no end in sight."[3]

Second, the Federal Reserve announced that it would accelerate its timeline to withdraw its accommodation. In the December Federal Open Market Committee (FOMC) meeting,

the Fed announced that it would begin reducing asset purchases within its quantitative easing program and that it planned to cease all purchases in the program by March. Further, the Fed indicated that shortly after ceasing new purchases, it would begin to raise interest rates and projected as many as three to four interest rates hikes in 2022.[4]

In December, the Federal Reserve announced that it would cease all asset purchases within its quantitative easing program by March. The Fed also indicated it would begin to raise interest rates and projected as many as three to four interest rates hikes in 2022.[4]

The Federal Reserve's decision to tighten accommodation and Manchin's retreat from additional fiscal stimulus are both related to the elevated levels and stickiness of inflation. The November reading of the Consumer Price Index jumped to 6.9% on a year-over-year basis, the highest since 1982.[5] This commonly quoted measure of inflation has now stayed above 5% for the past six months. This stretch of CPI readings that have hovered around 5% is the longest since 1982—when inflation was on a downward trajectory from a record high of 15%, set in 1980.[5]



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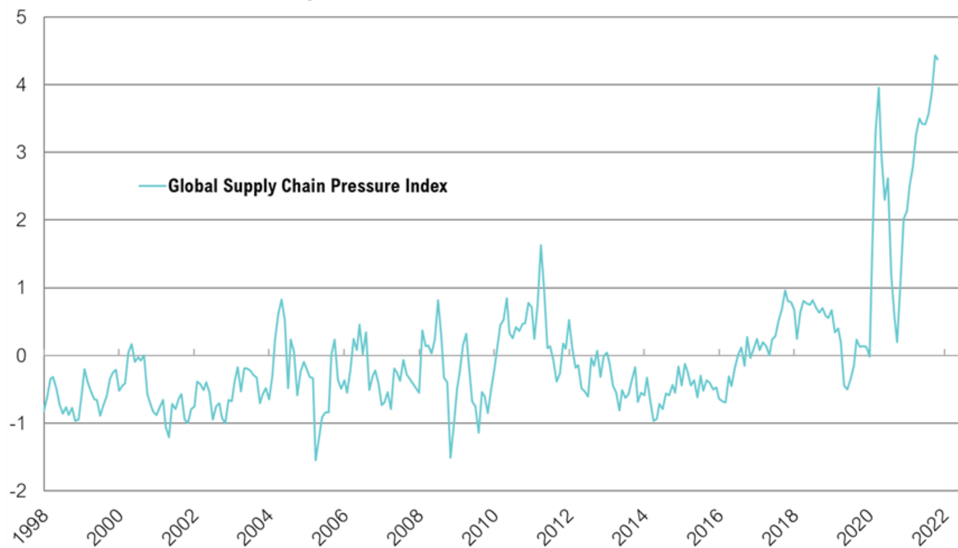
While policymakers' decisions to withdraw support and raise interest rates should reduce inflationary pressures, supply chain disruptions related to COVID-19 could counteract these efforts. While COVID-19 death rates remained well below prior waves, the U.S. reported six million total active cases in December— substantially more than the 2.5 million cases on average during the first eleven months of the year.[6] Outside the U.S., there were nearly 25 million cases in December alone, substantially more than the 16 million averaged through November.[7] The prevalence of the Omicron variant and government actions to limit its spread will continue to disrupt supply chains at least until the current surge is behind us. The Global Supply Chain Pressure Index uses 27 metrics to measure different dimensions of potential disruptions in global supply chains.[8] This indicator was showing extreme stress in November, even before the Omicron variant had emerged. Despite a challenging near-term outlook, supply chain issues could recede with the passage of time, less demand stemming from less fiscal and monetary stimulus, and the potential for COVID-19 to become endemic.



Less Candy in 2022

The Federal Reserve is set to purchase substantially fewer bonds in 2022—approximately $360 billion compared to the $1.2 trillion balance sheet expansion in 2021. At the same time, fiscal policymakers are poised to deliver meaningfully less support in 2022 after providing approximately $4 trillion of support over the past year.

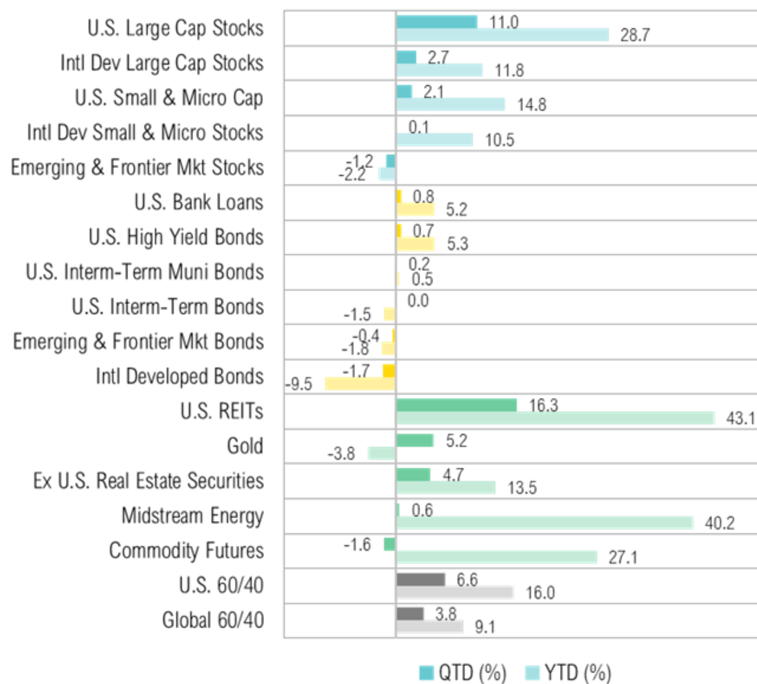
Both monetary and fiscal policymakers are poised to drastically reduce stimulus in 2022. Last year, the Federal Reserve expanded its balance sheet by $1.2 trillion through its bond-buying program ("quantitative easing").[2] Given that the program is expected to cease in March, the Fed is set to purchase substantially fewer bonds in 2022—approximately $360 billion.[4] At the same time, fiscal policymakers are poised to deliver meaningfully less support. Including the December 2020 legislation that extended the CARES Act with an additional $900 billion in stimulus,[9] last year saw the passage of the nearly $2 trillion American Rescue Plan Act[10] and an infrastructure bill estimated at just over $1 trillion.[1] In total, these programs provided approximately $4 trillion in support. Senator Manchin's single-handed defeat of the Build Back Better bill highlighted the divisions within the government, even as the Democrats control both the House and Senate.[11] Complicating matters further, President Biden's approval rating has fallen considerably, further impeding the Democratic agenda.[12] Finally, the U.S. is heading into mid-term Congressional elections. With the Build Back Better legislation tabled for now, it is safe to assume that fiscal stimulus in 2022 will trail 2021 levels—and substantially so. Withholding candy may help reduce inflation, but it will also affect financial markets, which have gorged themselves on the sweetness of low interest rates, cheap asset purchases, and plentiful stimulus checks. The withdrawal symptoms from nearly two years of an unprecedented sugar high will likely translate to heightened volatility across the economic and capital markets.

This significant reduction in stimulus will not necessarily cause a recession this year and we would caution against comparing the anticipated reduction in monetary support in early 2022 to the fourth quarter of 2018—the last time quantitative easing was significantly reduced. You may recall that the S&P 500 declined by 19% from October to December 2018. However, that drop was primarily in response to what many believe was a tightening gaffe: the Fed had raised interest rates eight times to 2.5% and had been shrinking its balance sheet for about a year.[13] However, although the two situations may be very different, markets have never experienced such an abrupt end to such dramatic levels of accommodation, so volatility should be expected.

Markets

Large cap companies in the U.S. dramatically outperformed other equity asset classes during the quarter, extending their already substantial lead coming into the final quarter of the year. The S&P 500 was higher by 11% in the quarter, pushing its return for 2021 to 29%. From an equity style perspective, large cap growth stocks gained 12% during the quarter while value stocks gained 8%. For the year, the Russell 1000 Growth Index finished higher by 28% while the Russell 1000 Value Index was higher by nearly as much, at 25%. From a smaller company perspective, the Russell 2000 Index gained 2% during the quarter, pushing the calendar-year return to 15%. Value stocks, as measured by the Russell 2000 Value Index, significantly outperformed the Russell 2000 Growth Index for the quarter and year. For the quarter, small value stocks were higher by 4%, leaving them up 28% for the year. Growth stocks were flat for the quarter and up marginally for the year, up 3%.

4Q, 2021 Key Market Total Returns



Source: Bloomberg

From a sector perspective during the quarter, gains were broad based. Several sectors produced double-digit gains, including, technology, real estate, utilities, materials, health care, consumer staples, and discretionary. Only communication services failed to post positive gains, posting 0% for the quarter overall. For the year, energy led the way with a 55% return, followed by real estate with a 46% return. Both sectors are among the smallest in the index and make up less than 6% of the S&P 500. Technology and financials were both up 35%. For context, these two sectors make up nearly 40% of the S&P 500.

Stocks outside of the U.S. trailed their U.S. counterparts during the quarter and in 2021. Developed market equity returns, as measured by the MSCI EAFE Index, gained 3% in U.S. dollar terms during the quarter. This moved the index higher by 11% for the year. The 18% return differential between EAFE and the S&P 500 was the third widest since 1997. The MSCI EAFE Index trailed the S&P 500 by 19% in 2014 and trailed by 32% in 1997 during the Asian currency crisis. In local currency terms, developed market equities

outside the U.S. were up 4% in the quarter and up 19% for the year. The MSCI Emerging Markets Index was down 1% during the quarter, leaving it down 2% for the year. In local currency terms, emerging market stocks were down 1% in the quarter and flat for 2021.

Looking Forward

The next year could usher in more volatility than investors have experienced in some time as the economy and markets adjust to lower levels of stimulus. In addition, monetary policy is not on a predefined course because it hinges on incoming data related to inflation, the labor market, and financial conditions, all three of which are now explicitly in the Fed's purview. Of these, we believe inflation will play the role of Lord Licorice—the main antagonist for markets this year. Further, incoming data will ebb and flow as the year progresses, so we believe monetary policy will be on a tug-and-pull course between incoming data and policymakers desire to support the economy. In a year like this, we are reminded of a quote often attributed to Mark Twain and Yogi Berra: it is dangerous to make forecasts, especially about the future. As such, we think investors will be well-served to err on the side of humility, discipline, and patience in 2022.

Performance Disclosures

All market pricing and performance data from Bloomberg, unless otherwise cited. Asset class and sector performance are gross of fees unless otherwise indicated.

Citations

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Asset Class Definitions

Asset class performance was measured using the following benchmarks: U.S. Large Cap Stocks: S&P 500 TR Index; U.S. Small & Micro Cap: Russell 2000 TR Index; Intl Dev Large Cap Stocks: MSCI EAFE GR Index; Emerging & Frontier Market Stocks: MSCI Emerging Markets GR Index; U.S. Interm-Term Muni Bonds: Bloomberg Barclays 1-10 (1-12 Yr) Muni Bond TR Index; U.S. Interm-Term Bonds: Bloomberg Barclays U.S. Aggregate Bond TR Index; U.S. High Yield Bonds: Bloomberg Barclays U.S. Corporate High Yield TR Index; U.S. Bank Loans: S&P/LSTA U.S. Leveraged Loan Index; Intl Developed Bonds: Bloomberg Barclays Global Aggregate ex-U.S. Index; Emerging & Frontier Market Bonds: JPMorgan EMBI Global Diversified TR Index; U.S. REITs: MSCI U.S. REIT GR Index, Ex U.S. Real Estate Securities: S&P Global Ex-U.S. Property TR Index; Commodity Futures: Bloomberg Commodity TR Index; Midstream Energy: Alerian MLP TR Index; Gold: LBMA Gold Price, U.S. 60/40: 60% S&P 500 TR Index; 40% Bloomberg Barclays U.S. Aggregate Bond TR Index; Global 60/40: 60% MSCI ACWI GR Index; 40% Bloomberg Barclays Global Aggregate Bond TR Index.

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