January 3, 2022 • Portfolio Management Team

# Covid-~~19~~ 22

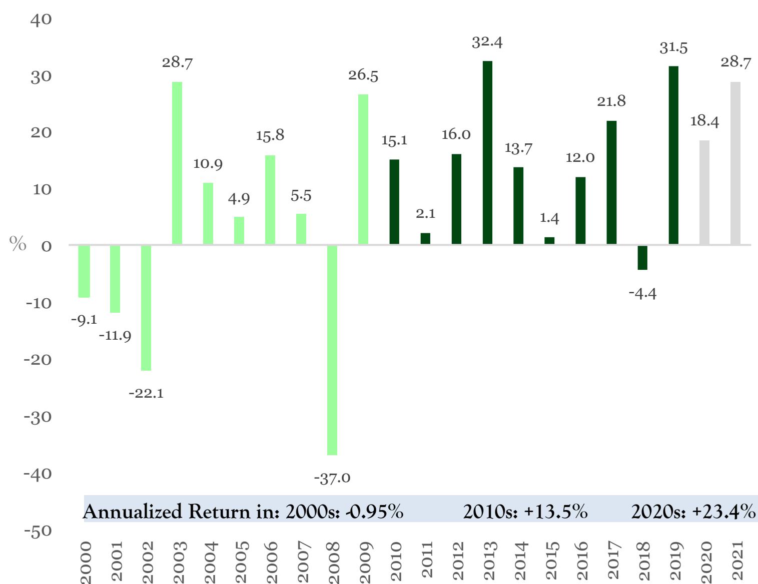
It is hard to believe that we are still living in a pandemic. What began as "two weeks to slow the spread" has turned into two years of disruption and change. Now, the emergence of the Omicron variant has further complicated the return to normalcy.

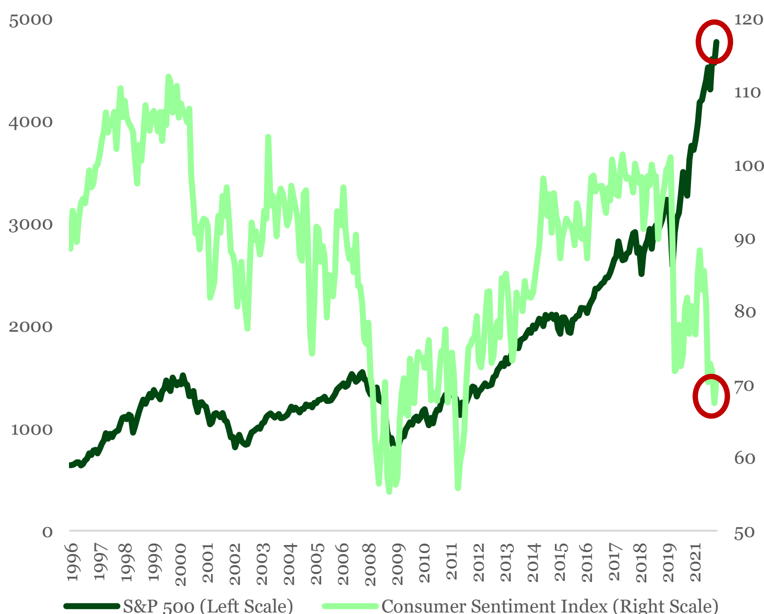
Financial markets have fared surprisingly well since March of 2020. U.S. stocks have performed better during the pandemic than in the years prior to it (left chart). Nobody predicted this, yet there are good reasons that explain the rise in stocks and why the bull market should continue. This includes how businesses have taken advantage of the pandemic to grow profits -- a focus of this report.

Despite strong performance from stocks, consumer sentiment is near record lows. Inflation, political turmoil, and the pandemic are all taking a toll on Americans. In fact, there has never been such a divergence between the stock market and consumer sentiment. The two usually move together, but even though stocks are up, Americans feel down about the economy (right chart).

We're often asked: how can stocks perform so well in the face of so many difficulties? Part of the answer is that the stock market looks beyond challenges like inflation and the pandemic, even as Americans are mired in them. But the primary reason is that the market reflects the success of corporate America. Large, publicly-traded companies have prospered during the pandemic. This has driven stocks higher and should continue to do so in 2022.

In this quarter's report, we review market performance in 2021 and discuss why, in spite of the challenges, we expect 2022 to be a good year for investors.




Source for charts: Hefren-Tillotson, Bloomberg, , Past performance does not predict future results Data as of 12/31/21

# Asset Class Returns as of 12/31/2021

| | | Latest Quarter | Year-to-Date | 1 Year | Annualized Return 3 Year | 5 Year | 10 Year | Current Yield | Forward P/E |
|---|---|---|---|---|---|---|---|---|---|
| Fixed Income | **Domestic Taxable** | | | | | | | | |
| | Barclays Capital US Treasury Index | 0.2 | (2.3) | (2.3) | 4.1 | 3.1 | 2.1 | 1.2 | |
| | Barclays Capital US Aggregate | 0.0 | (1.5) | (1.5) | 4.8 | 3.6 | 2.9 | 1.8 | |
| | Barclays Capital Corporate | 0.2 | (1.0) | (1.0) | 7.6 | 5.3 | 4.7 | 2.3 | |
| | Barclays Capital High Yield | 0.7 | 5.3 | 5.3 | 8.8 | 6.3 | 6.8 | 4.2 | |
| | **Domestic Tax Exempt** | | | | | | | | |
| | Barclays Municipal Bond Index | 0.7 | 1.5 | 1.5 | 4.7 | 4.2 | 3.7 | 1.1 | |
| | BarCap Muni High Yield | 1.2 | 7.8 | 7.8 | 7.7 | 7.5 | 6.7 | 3.1 | |
| | **International/Global** | | | | | | | | |
| | Barclays Capital Global Aggregate | (0.7) | (4.7) | (4.7) | 3.6 | 3.4 | 1.8 | 1.3 | |
| | Barclays Capital Emerging Market Bond | (0.8) | (2.6) | (2.6) | 5.4 | 4.5 | 4.8 | 4.0 | |
| Equity | **Domestic Equities** | | | | | | | | |
| | S&P 500 Index | 11.0 | 28.7 | 28.7 | 26.0 | 18.4 | 16.5 | 1.3 | 22.8 |
| | Dow Jones Industrial Average | 7.9 | 20.9 | 20.9 | 18.5 | 15.5 | 14.2 | 1.7 | 18.7 |
| | S&P Mid Cap Index | 8.0 | 24.7 | 24.7 | 21.4 | 13.1 | 14.2 | 1.4 | 17.6 |
| | Russell 2000 | 2.1 | 14.8 | 14.8 | 20.0 | 12.0 | 13.2 | 1.2 | 31.7 |
| | **Investment Styles** | | | | | | | | |
| | S&P 500 Value | 8.3 | 24.9 | 24.9 | 18.6 | 11.9 | 13.3 | 2.0 | 18.5 |
| | S&P 500 Growth | 13.4 | 32.0 | 32.0 | 32.2 | 24.1 | 19.2 | 0.6 | 28.8 |
| | **Foreign Equities** | | | | | | | | |
| | MSCI World | 7.9 | 22.4 | 22.4 | 22.3 | 15.6 | 13.3 | 1.7 | 20.3 |
| | MSCI EAFE | 2.7 | 11.9 | 11.9 | 14.2 | 10.1 | 8.6 | 2.6 | 15.9 |
| | MSCI Emerging Markets | (1.4) | (2.5) | (2.5) | 11.2 | 10.2 | 5.8 | 2.4 | 12.4 |
| Other | **Other Assets** | | | | | | | | |
| | Bloomberg Commodity Index | (1.6) | 27.1 | 27.1 | 8.9 | 2.5 | (3.4) | 0.0 | |
| | Dow Jones Global Real Estate Index | 11.7 | 31.2 | 31.2 | 13.0 | 8.2 | 9.5 | 2.8 | 37.9 |
| | Gold | 4.1 | (4.1) | (4.1) | 12.1 | 9.3 | 1.2 | 0.0 | |

Source: Hefren-Tillotson, Bloomberg

Data as of 12/31/2021

## S&P 500 Sector Returns

| INDEX | % Return Q4 | % Return 2021 | % Return 2020 |
|---|---|---|---|
| Energy | 7.9% | 54.4% | -43.9% |
| Financials | 4.5% | 34.9% | -0.5% |
| Real Estate | 17.5% | 46.1% | -5.3% |
| Materials | 15.2% | 27.3% | 18.3% |
| Industrials | 8.6% | 21.1% | 17.9% |
| Telecom | 0.0% | 21.6% | -5.9% |
| Health Care | 11.2% | 26.1% | 16.0% |
| Technology | 16.7% | 34.5% | 47.3% |
| Staples | 13.3% | 18.6% | 10.9% |
| Consumer Discretionar | 12.8% | 24.4% | 29.8% |
| Utilities | 12.9% | 17.7% | -0.6% |

### Morningstar Categories 2021 % Return

| | Value | Blend | Growth |
|---|---|---|---|
| Large | 26.1 | 26.0 | 20.7 |
| Mid | 28.8 | 23.5 | 12.9 |
| Small | 31.5 | 24.2 | 12.2 |

### Style Box Fwd P/E Ratio Russell Indices

| | Value | Blend | Growth |
|---|---|---|---|
| Large | 17 x | 23 x | 33 x |
| Mid | 19 x | 24 x | 43 x |
| Small | 21 x | 32 x | 66 x |

## Inflation, the Economy, and Interest Rates

| | Current | 1 Year Ago | Change |
|---|---|---|---|
| Fed Funds Rate | 0.25% | 0.25% | - |
| Prime Rate | 3.25% | 3.25% | - |
| 10 Year US Treasury | 1.51% | 0.90% | ↑ |
| 30yr PA Mortgage | 3.3% | 2.9% | ↑ |
| GDP Growth % | 4.9% | -2.9% | ↑ |
| Industrial Production | 5.3% | -4.7% | ↑ |
| Retail Sales | 18.2% | 3.5% | ↑ |
| Consumer Sentiment | 70.6 | 80.7 | ↓ |
| Consumer Price Index | 6.8% | 1.2% | ↑ |
| Unemployment Rate | 4.2% | 6.7% | ↓ |
| U.S. Gov't Surplus/Deficit | -11.6% | -15.0% | ↓ |
| Initial Jobless Claims | 191k | 904k | ↓ |
| U.S. Dollar Index | 95.7 | 89.9 | ↑ |
| Gold | $1,829 | $1,905 | ↓ |
| Oil Prices | $75 | $49 | ↑ |
| Home Prices Index | 18.4% | 8.1% | ↑ |

Source: Hefren-Tillotson, Bloomberg, Data as of 12/31/21. Past performance does not predict future results.

## Market Review

Markets delivered strong results in 2021. Below are highlights from the year.

**U.S. Stocks** surged higher. Credit goes to booming corporate profits. Wall Street analysts estimate that earnings for S&P 500 companies grew 45%. Big Tech companies, which comprise 25% of the index and 8 of the 10 largest stocks, have thrived as the economy moved online during the pandemic. For perspective, Microsoft's earnings per share for 2021 are expected to be four times what they were in 2018, a massive increase for what was already one the world's most profitable companies.

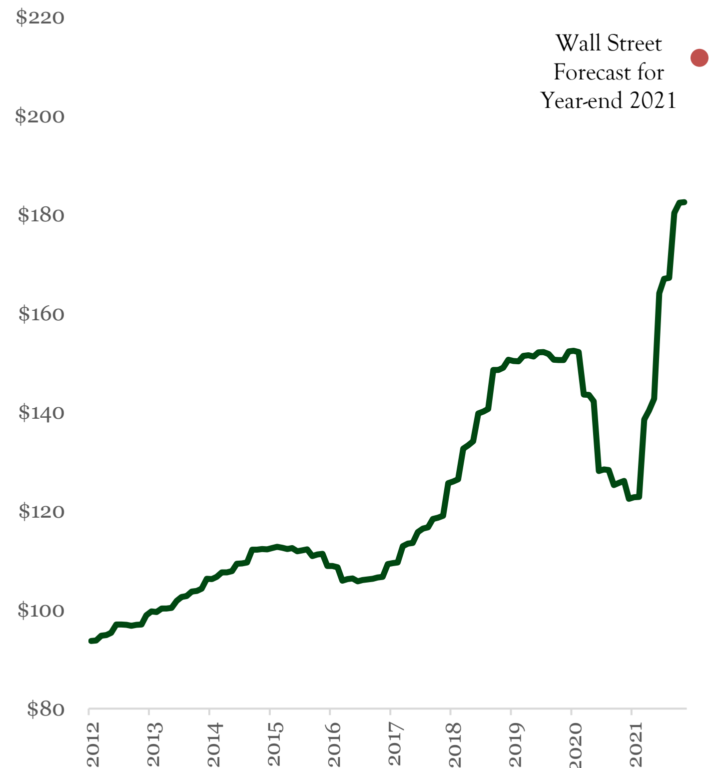
Small and mid-sized stocks didn't match the S&P 500's 28.7% return, but still delivered handsome gains, up 14.8% and 24.7%, respectively. Economically-sensitive small cap value stocks like banks and industrials performed well after struggling in 2020. Meanwhile, many IPOs and innovative small cap growth companies, which performed well in 2020, underperformed as investors sought stocks tied to the economic recovery.

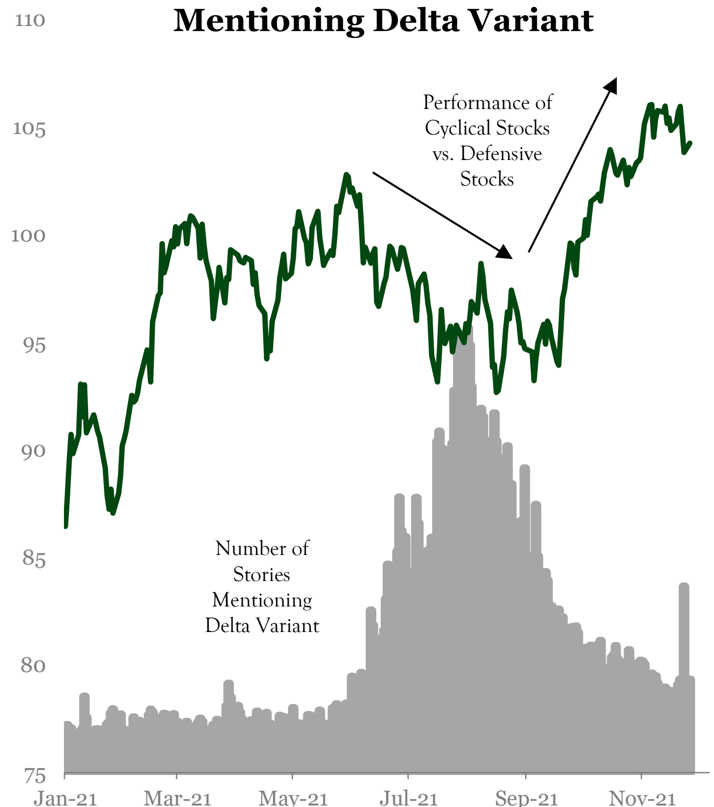
**Fixed Income:** If you had told us one year ago that inflation would reach nearly 7% in 2021, yet investment grade bonds, which are typically sensitive to rising inflation, would lose only 1.5%, we would have been pleasantly surprised. Interest rates stayed low last year and bond prices held firm thanks to accommodative Federal Reserve policy. Parts of the bond market even made money, including municipal bonds, with federal government stimulus filling state and local coffers and improving the financial shape of municipal issuers.

**Foreign stocks** gained 22% in foreign currency terms, but only 11.9% when translated into dollars. A stronger U.S. dollar weighed on returns. Emerging Market stocks fared worse, declining 2.5%. Chinese stocks fell 21% after a government crackdown on giant technology companies. Excluding Chinese stocks, Emerging Markets were up 10%.

**Covid**, despite its huge impact on the globe, did not restrain market returns. An argument can even be made that Covid has helped stocks by prompting government stimulus and creating an economic environment where large corporations can flourish. Thus, even if an investor successfully predicted the extent of the pandemic, he or she likely got the market implications wrong.

That being said, the trend in cases influenced market leadership last year (bottom chart). That will likely continue in 2022.




Source for charts: Hefren-Tillotson, Bloomberg, Strategas Research; Data as of 12/31/21. Past performance does not predict future results.

## Profits, Profits, Profits

The U.S. stock market has performed well for a simple reason: as the economy has grown, companies have captured increasing amounts of that growth and turned it into profits. This trend has been in place for decades and has been turbocharged by the pandemic.

Corporate profits have reached a record high of nearly 12% of GDP, double the average of recent decades (top chart). There are several reasons for this.

First, companies today are better at making money, plain and simple. Profit margins have reached a record high as corporate America became laser-focused on the bottom line (middle chart).

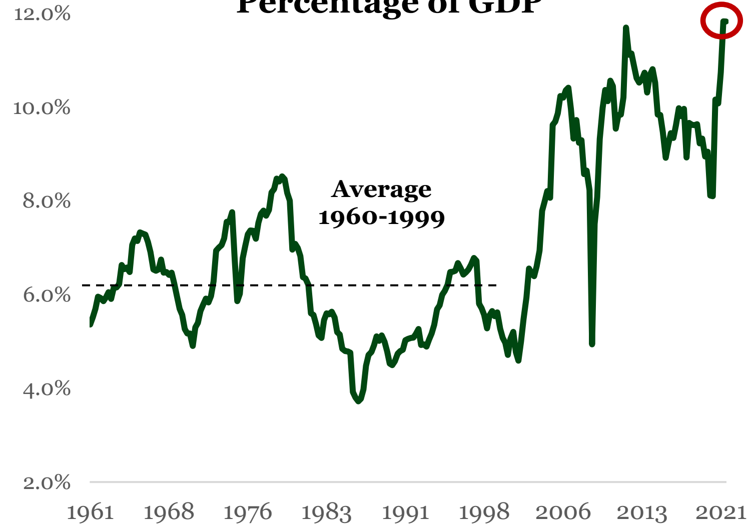
The second reason is that companies have expanded overseas. In the year 2000, one-third of S&P 500 profits were generated outside the United States. That has grown to one-half of profits. Moving overseas allows companies to reach new customers and to cut costs through global supply chains.

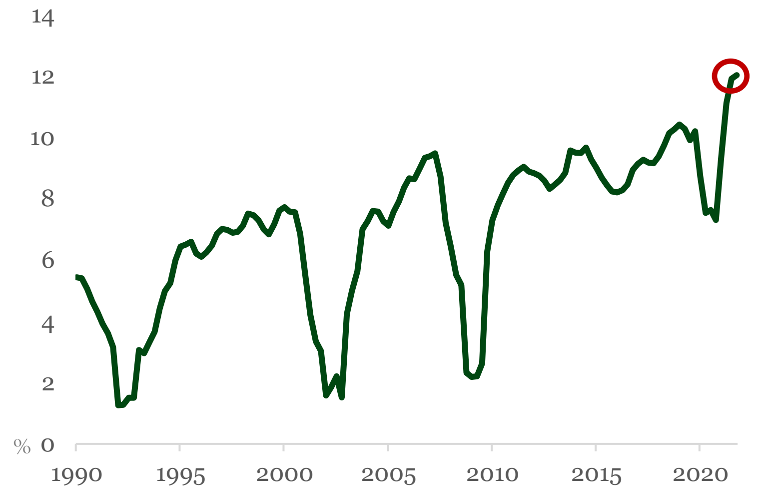
The third reason is obvious but easy to overlook. More profits are going to the large companies that make up the stock market, and a smaller percentage is going to small businesses. This accelerated during the pandemic as large corporations captured business that moved online (bottom chart).

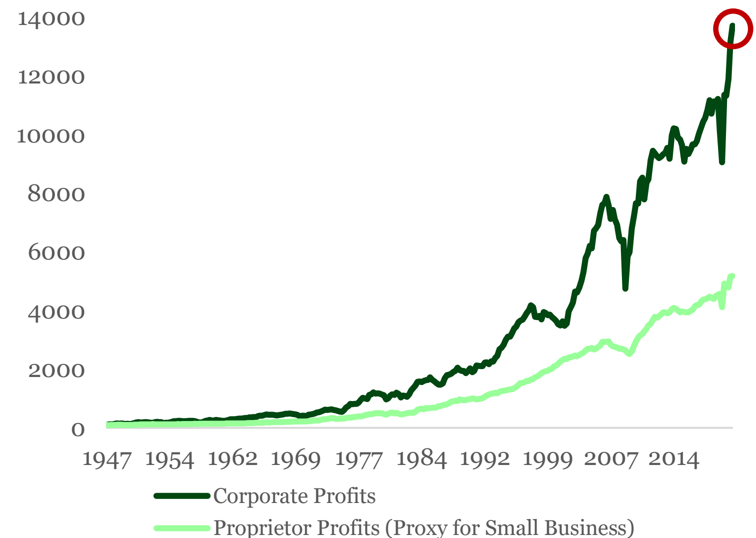
A few examples will help to elucidate this shift. Many readers will remember when Walmart expanded nationwide in the 1990s. The company took advantage of changes to the economy like NAFTA and globalized supply chains to cut prices and win customers from small retailers. Now, history is repeating itself. While brick and mortar stores struggle to attract foot traffic during the pandemic, Walmart has embraced e-commerce. And while small businesses fight to keep items in stock because of supply chain problems, Walmart charters its own cargo ships to secure goods.

The worker shortage is another area where large corporations have gained an edge. Prior to the pandemic, roughly 1 in 100 retail workers worked in Amazon warehouses. Now it is closer to 1 in 14. Amazon raised wages early in the pandemic to attract workers who were displaced by shutdowns. Now, small businesses can't find workers and must limit their hours of operation. Amazon, of course, is always open.

Trends like these help Wall Street and stock prices even as small business challenges are felt on Main Street and likely contribute to poor consumer sentiment.




Source for all charts: Hefren-Tillotson, Bloomberg, Data as of 12/31/21. Past performance does not predict future results.

## That 70's Show?

Rising inflation is another development more beneficial to stocks than individuals. Businesses have used the inflationary environment to raise prices and boost profits. Sales for S&P 500 companies likely grew 15% in 2021, and two-thirds of companies have raised prices at least as much as their costs have risen. As a result, nearly one-fifth of S&P 500 companies have seen profit margins rise at least 50% higher than pre-pandemic levels. Some inflation, it turns out, can be good for stocks.

Of course, this can't go on forever. Businesses aren't helped if Americans can't afford goods or services, or if costs rise faster than companies can raise prices. Runaway inflation is bad for stocks. But we are not there yet, nor do we expect to be anytime soon.

To understand why, it helps to revisit the experience of the 1970's when inflation spiraled out of control. In 1974, President Gerald Ford addressed a joint session of Congress and urged Americans to "Whip Inflation Now." He gave practical advice: lower the thermostat, plant a garden, and walk short distances instead of driving. These were sensible ideas, but the fact that they were the centerpiece of the nation's inflation strategy strikes economists today as primitive and misguided.

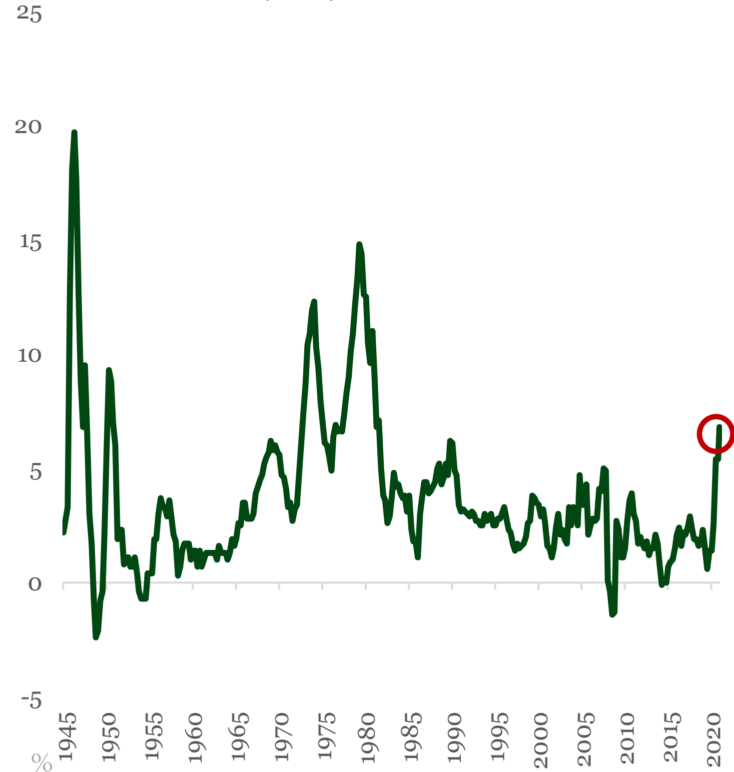
It was not until the 1980's that economists appreciated the central role of the Federal Reserve in regulating inflation. For the next forty years, whenever inflation rose, the Fed raised interest rates. While this caused recessions and temporary declines in the stock market, it kept inflation low.

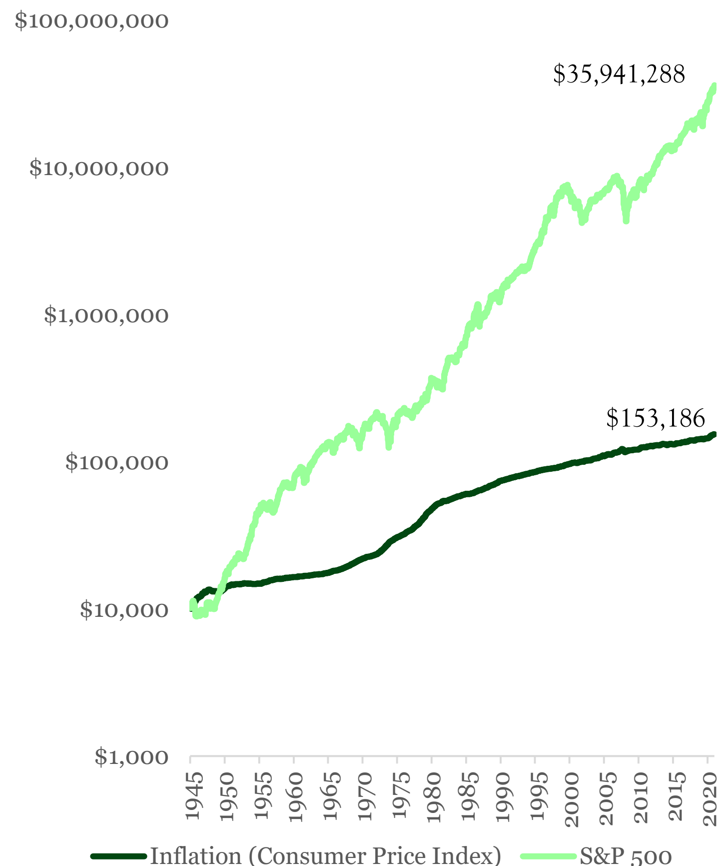
Today, the Fed has pledged to again raise rates if necessary to combat inflation. Thus, while inflation may stay elevated during the pandemic, we do not think the Fed will allow runaway inflation to return.

Surprisingly, the 1970's wasn't a terrible decade for investors. The S&P 500 rose 5.9% annualized. Small cap stocks rose 11%. Even bonds had solid returns, gaining 6.8%. Bond prices fell as interest rates rose, but investors were able to re-invest at higher rates.

The experience of the 1970's and 2021 is a reminder that inflation is a risk but also a reason to stay invested and not abandon stocks and bonds. Sitting in cash last year would have lowered one's purchasing power by nearly 7% due to inflation.

Thus, when you hear about inflation, our advice is: Don't get mad, get even. Owning stocks and stock mutual funds means owning a share in companies that can turn rising prices into profits.




Source for both charts: Hefren-Tillotson, Bloomberg, Morningstar, Data as of 12/31/21. Past performance does not predict future results.

## Outlook for 2022

**U.S. Stocks -** We expect U.S. stocks to perform well in 2022. The factors that drove returns last year should continue. Wall Street analysts expect 2022 profits to grow 9%. It could even be a very good year for stocks if there are twin victories over inflation and Covid. The two are connected - if the pandemic subsides then inflation should too.

That being said, we expect more volatility. 2022 is a mid-term election year. Stocks have experienced a significant decline in every mid-term year since 1950, with an average drawdown of 17% peak-to-trough (top chart). But in every case since 1950, stocks were higher 12 months from the mid-term year low, on average by 32%. Thus, investors should look past any short-term drop.

Ultimately, this unconventional market cycle may end in conventional fashion, with the Federal Reserve raising interest rates to fight inflation. But that is unlikely to occur in 2022. Investors expect the Fed to raise rates three times this year. It may be another year or two before interest rates rise to a level that slows the economy, and even longer before higher rates cause a recession. Thus, we can envision the bull market lasting until 2024 or beyond.

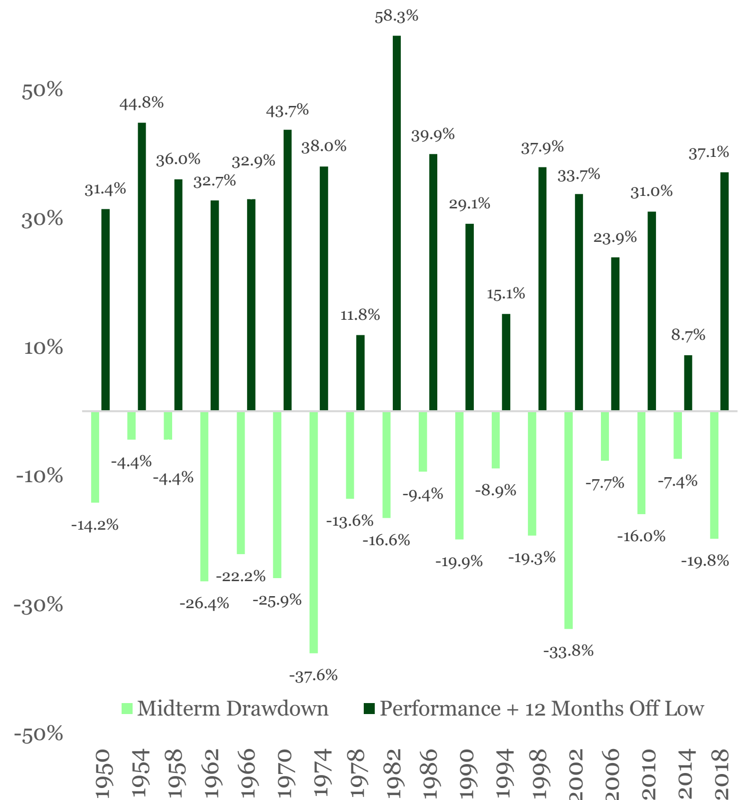
Of course, pinpointing market tops is impossible and the world today is full of surprises. But our general sense is that investors should be optimistic.

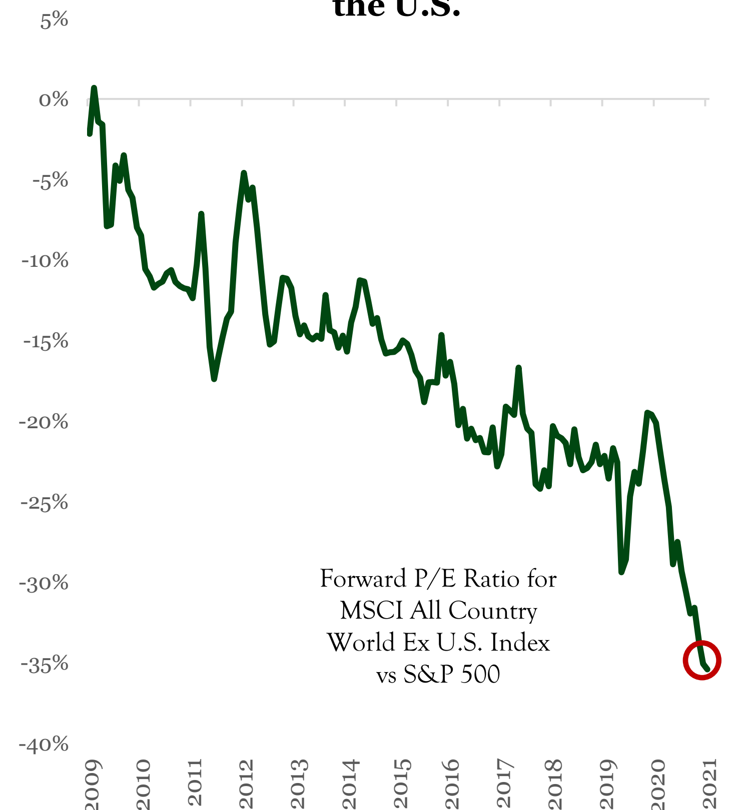
**Foreign Stocks -** Foreign markets have delivered solid results over the past decade but have lagged U.S. stocks. Looking ahead, there are three dynamics to watch.

First, the U.S. dollar is likely to decline, which would boost overseas returns. The dollar appears to be expensive, and large U.S. fiscal and trade deficits could drag it lower. The second dynamic is valuations. Foreign stocks are cheap compared to U.S. stocks, which means there is catch-up potential, but only if the third factor – economic growth – improves.

China is the key to watch in this regard and is the main driver of growth outside the United States. China faces near-term challenges, including a troubled real estate sector and a "zero Covid" policy that restrains activity. But the country also has a credible plan for long term growth. "China 2025" aims to transform the economy into a technology-centered powerhouse. China's success or failure will influence foreign market returns.

We will watch foreign markets closely in 2022. After years of underperforming the U.S., foreign stocks ought to perform better if the global economy can exhale from the pandemic. If not, we may recommend reducing exposure despite low valuations.




Source for both charts: Hefren-Tillotson, Bloomberg, Data as of 12/31/21. Past performance does not predict future results.

## Outlook, Continued

**Fixed Income -** Interest rates are low and investors should expect modest returns from bonds. But there are areas of opportunity. Parts of the municipal and corporate bond markets offer solid yields and some foreign bond markets should perform well if the dollar weakens. A multi-sector bond fund can search across markets for investments.

Better fixed income options should emerge in the future. Either rates will rise as the economic expansion continues, or the next recession will create more opportunities in corporate and high yield bonds. Until that day, investors should be patient and keep "dry powder" on hand in the form of short-term bond funds.

Our top piece of advice for bond investors is to avoid long-term Treasury bonds. The 30-year Treasury bond yields 1.9% today but stands to lose more than 20% if rates were to rise a mere 1%.

**Real Estate -** Real estate had a strong 2021 (+31%) but that likely represents a bounce from being oversold in 2020 and not the beginning of a new trend.

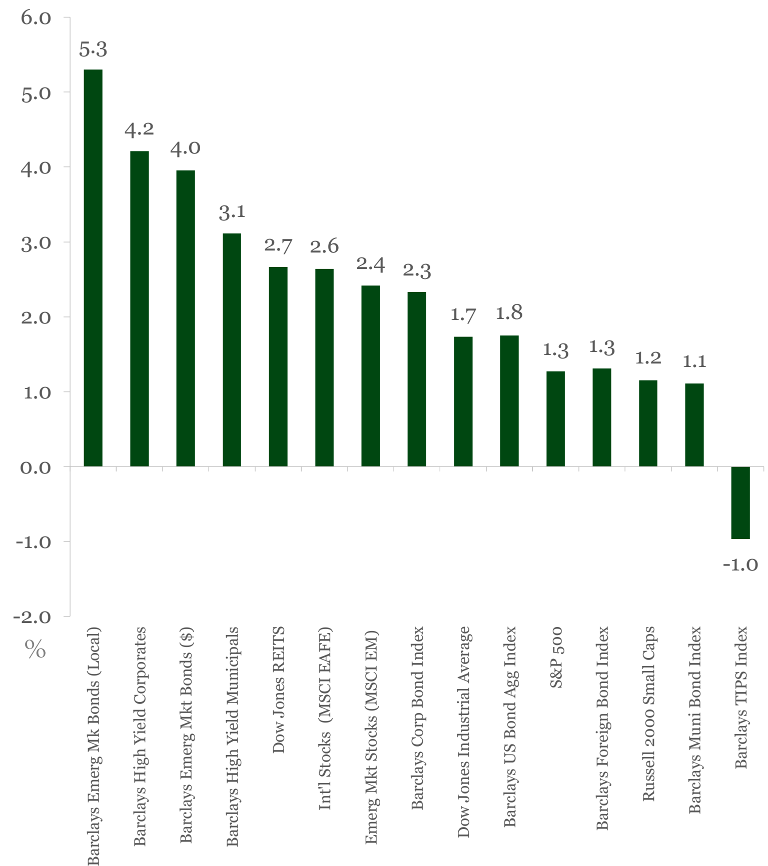
The future of the economy is virtual. Offices and retail space will recover from COVID, but only partially. More Americans now work and shop online. Younger generations have been shaped by the pandemic and will steer the economy in a digital direction. Kids now visit Santa on Zoom and attend virtual birthday parties dressed as their favorite digital character.

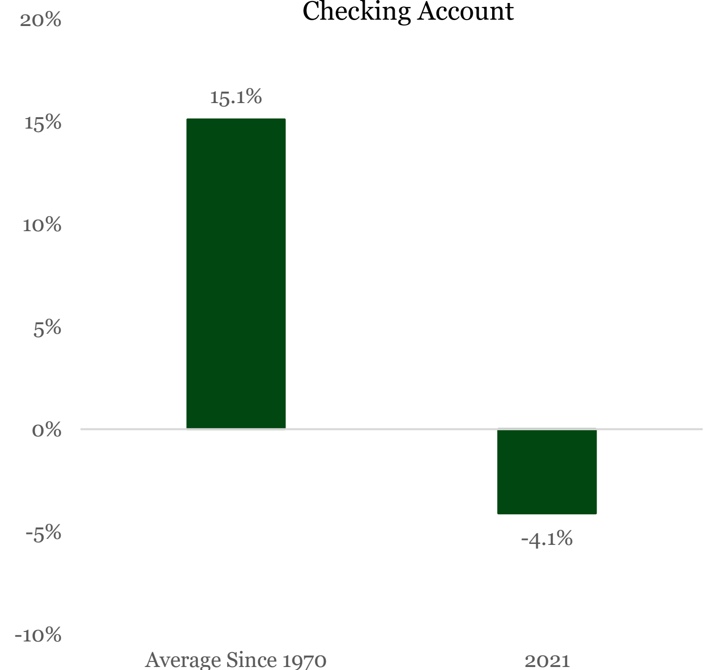
There will still be opportunities in real estate, perhaps for example in e-commerce warehousing and data centers that support the virtual economy. But real estate-focused investors should use an active manager that can navigate these trends.

**Commodities and Gold-** We don't recommend owning commodities today, even if they offer protection from higher inflation.

Oil and gas prices may rise as the economy rebounds, but there is a limit to how high prices can go. Fracking has made drilling for oil and gas easier, and supplies should be ample.

Gold prices fell in 2021 despite the rise in inflation. Cryptocurrencies are outcompeting gold as an alternative currency. To see gold knocked from a perch it has held for most of recorded history is truly remarkable, and shows how much the world has changed.




Source for both charts: Hefren-Tillotson, Bloomberg, Data as of 12/31/21.
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## What Could Go Wrong?

One risk to the outlook is continued high inflation. The risk probably isn't inflation itself, but rather the Fed's response to it. Aggressive rate hikes have caused many recessions and bear markets, but stocks have always recovered.

We think the market will be able to handle the impact of the Omicron variant. Omicron is highly transmissible, which means that surges in cases will be rapid. More broadly, Americans are habituated to the pandemic and lawmakers are averse to new shutdowns, so the economic effects should be limited. Our main concern is that Omicron exacerbates supply chain troubles and thus inflation pressures.

If there's a risk that could spoil the longer-term outlook, it's that U.S.-China relations deteriorate and globalization goes into reverse. The trend since World War II of more cooperation among nations has helped the global economy. A splintering of the global order could mean slower growth, higher inflation and smaller profits. Although U.S.-China relations are tense, remember that during the U.S.-Soviet Cold War it was a mistake to invest based on fear of the worst-case scenario.

The last risk is elevated valuations for stocks, at least for the S&P 500. While a high Price to Earnings ratio won't cause a bear market, it could limit returns. But market returns that are average or even below-average should still allow investors to outpace inflation and grow their purchasing power.

## A Final Word

Covid isn't the first crisis for investors, and it won't be the last. This century began with the dot com bust and 9/11. Then came the 2008 global financial crisis. The S&P 500 has performed well nevertheless, returning 7.5% annualized, even with the tech bubble as a starting point. No doubt, more obstacles and crises await. But if companies overcame the traumas this century, we believe they'll prosper despite the inevitable challenges ahead.

## Investment Strategy Summary

### Outlook and Strategy Overview

- The bull market should continue in 2022, but the pace of gains should moderate and volatility should rise in a mid-term election year. A pullback could be a buying opportunity.
- Longer-term, we believe the U.S. economy is on the verge of a "New New Normal," where innovation combines with strong consumer and business fundamentals to create opportunities for investors.
- U.S. stocks are somewhat expensive but that should improve as earnings grow.
- Both Growth and Value style stocks appear attractive. Value stocks should benefit as the economy recovers. But Growth stocks, especially innovative technology companies, may be the long-term winners.
- Foreign stock market performance should improve as the global economy recovers from the pandemic. If not, we'll consider reducing exposure.
- Emerging markets offer attractive valuations and growth opportunities, but China is a wildcard.
- Interest rates may rise in 2022 as the Fed reverses course on monetary policy. But rates should remain historically low and their rise shouldn't cause a recession. Fixed-income investors can own short-term bond funds as they await better opportunities.
- The main risk for 2022 is that high inflation persists and forces the Fed to aggressively raise rates. This is possible but not likely.
- Investors should wait and see on tax law changes. Major changes didn't occur in 2021, but could in 2022. Remember that tax rates went up in the 1990's and 2010's but stocks had good returns both decades.
- Uncertainty in Washington will continue, but is mostly "noise" for investors. Focus instead on corporate fundamentals.

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