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Investment Insights Monthly

From The Desk of Bill Hornbarger, Chief Investment Officer

December 2021

Monetary Policy Evolves

The Federal Open Market Committee (the Fed) met for the final time in 2021 on December 14th and 15th. In the days surrounding the meeting, the Consumer Price Index (CPI) printed the highest inflation rate since 1982 (6.8%), the S&P 500 index achieved a new all-time high, the national median home price hovered near record high levels (up 17% from a year earlier per the Federal Housing Finance Agency), and weekly initial jobless claims fell to the lowest level in more than 50 years.

Since the beginning of the pandemic in March of 2020, the Fed has adopted a stance of extraordinary monetary policy and been very patient in removing stimulus, even as the economy has recovered and inflation has increased. In November the Fed announced that it would begin the process of tapering by reducing the monthly pace of its net asset purchases (called quantitative easing) by $10 billion for Treasury securities and $5 billion for agency mortgage-backed securities. At that time, the committee also communicated that it would continue to reduce asset purchases by the same amount going forward, resulting in a cessation of bond purchases by July of 2022. The Fed also indicated it would not increase interest rates until tapering was completed.

At the recently concluded December meeting the narrative changed, with the Fed no longer describing inflation as transitory and stating that, "Job gains have been solid in recent months, and the unemployment rate has declined substantially. Supply and demand imbalances related to the pandemic and the reopening of the economy have continued to contribute to elevated levels of inflation."

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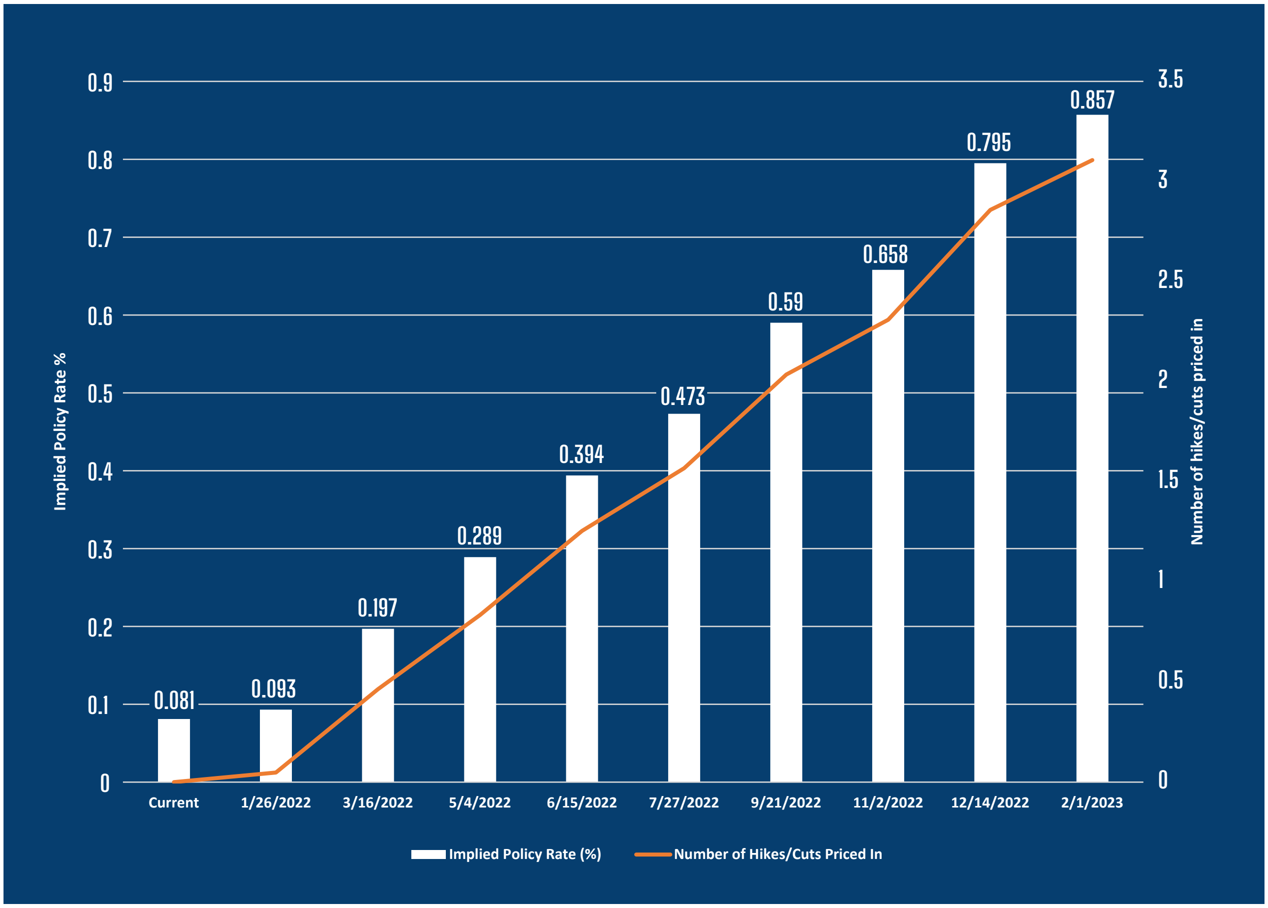
In response to this evolving outlook, the Fed also changed its projections on monetary policy by accelerating the pace of tapering. "The Committee decided to reduce the monthly pace of its net asset purchases by $20 billion for Treasury securities and $10 billion for agency mortgage-backed securities. Beginning in January, the Committee will increase its holdings of Treasury securities by at least $40 billion per month and of agency mortgage backed securities by at least $20 billion per month. The Committee judges that similar reductions in the pace of net asset purchases will likely be appropriate each month, but it is prepared to adjust the pace of purchases if warranted by changes in the economic outlook." If policymakers adhere to the new schedule, tapering would be concluded in the spring (vs. July previously), paving the way for potential rate increases in the first half of 2022. The projection materials (the "dot plot") released with the December statement indicate that the majority of Fed officials now see three rate increases in 2022, three more in 2023, and two in 2024. That would result in the target Fed rate being in the 2% to 2.25% range by the end of 2024. The dot plot also indicates that Fed officials see the long-term neutral Fed funds rate at 2.5%.

Implied Interest Rate Probability
December 15, 2021



Source: Bloomberg

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Many investors worry about rising rates and the impact on their portfolios, whether it is the potential for declines in bond prices, lower valuations for stocks because of the competition from higher bond yields, or the higher debt service load for everyone from governments to individuals.

These risks are real and a cause for concern, but rising rates are not bad for everyone. Some of the beneficiaries include:

- Savers – Money markets funds, certificates of deposit, Treasury bills, and other short-term instruments all will likely see yields increase as/if the Fed raises rates.
- Bond buyers – While rising yields can have a negative impact on bond prices, investors in new fixed income holdings should benefit from higher prevailing market yields as the market reprices to a new environment.
- Hedge fund managers – Many of these funds short securities as part of their strategy or use futures and as result hold more cash and cash type instruments (T-bills) as collateral. Low rates have been a headwind in recent years and the ability to earn any positive return on cash could be additive to performance.
- Financial companies – The financial sector has historically been among the most sensitive to changes in interest rates. With profit margins that actually expand as rates climb, entities like banks, insurance companies, brokerage firms, and money managers generally benefit from higher interest rates.

The Fed has been very transparent in its thoughts, and the Fed and market-based indicators now seem aligned on the path of monetary policy. And based on market activity, the market appears to be comfortable with this path and the ability for the economy to absorb measured rate increases. The current dot plot indicated eight increases over a three-year period. Contrast that to 2004-2006 when the Fed raised rates 17 times. It is also important to note that the target Fed funds rate will likely remain below the rate of inflation for multiple periods despite any potential rate increases. While we expect volatility around these events, monetary policy should remain neutral to a tailwind for equities as we move into 2022, allowing investors to focus on the broader economic themes and earnings.

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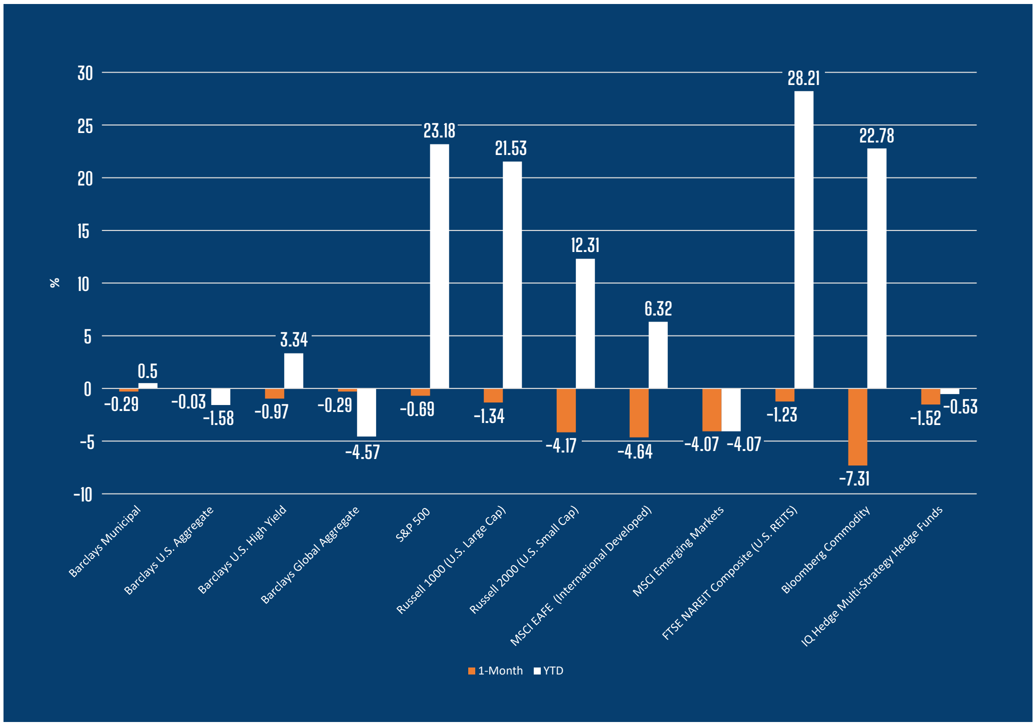
Asset Class Returns as of November 30, 2021

Comparing Recent Month and Year-to-Date Total Returns



Source: Morningstar

Fixed Income

- Treasury and sovereign bond yields moved lower last month, boosting core fixed income and municipals.
- High yield sold off with other risk assets, but floating rate loans benefited from their position as a hedge against higher rates.
- Bonds outside the U.S. were hit hard by USD strength.

Equities

- U.S. equities were mostly weak in November outside of growth/tech stocks.
- Small cap stocks were particularly weak relative to large cap stocks.
- In large cap, growth beat value, but small cap growth was weak versus small cap value.
- Non-U.S. equities underperformed U.S. equities last month with substantial weakness in value stocks, Europe, and emerging markets.
- Growth beat value outside the U.S., and large cap outperformed small cap.
- Emerging market equities fell more than 4% led by declines in Eastern Europe and China.
- U.S. dollar strength detracted 214 basis points from EAFE returns but added 86 bps to emerging market returns.

Real Assets

- Both commodities and domestic REITS were weak in November.
- The Bloomberg Commodity Index was off more than 7% during the month. Energy in particular was soft, with crude oil and natural gas down 7.87% and 10.76% respectively.

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November 30, 2021	MTD	QTD	YTD	1-Year	3-Year	5-Year	10-Year
Fixed Income Indices							
Barclays U.S. Treasury Bill 1-3 Month	0.01%	0.01%	0.04%	0.04%	0.99%	1.09%	0.58%
Barclays Municipal	0.85%	0.56%	1.35%	1.97%	5.09%	4.38%	3.90%
BBgBarc U.S. Govt/Credit Intermediate	-0.08%	-0.41%	-0.32%	-0.23%	2.59%	1.90%	1.41%
Barclays U.S. Aggregate	0.30%	0.27%	-1.29%	-1.15%	5.52%	3.65%	3.04%
Barclays U.S. High Yield	-0.97%	-1.14%	3.34%	5.29%	7.39%	6.29%	6.91%
S&P/LSTA Leveraged Loan	-0.16%	0.11%	4.53%	5.94%	4.51%	4.38%	4.68%
Barclays Global Aggregate	-0.29%	-0.53%	-4.57%	-3.29%	4.34%	3.29%	1.85%
JPM GBI EM Global Diversified	-2.74%	-4.03%	-10.15%	-7.02%	1.98%	2.88%	0.44%
U.S. Equity Indices							
DJ Industrial Average	-3.50%	2.22%	14.61%	18.52%	12.95%	15.05%	13.78%
S&P 500	-0.69%	6.26%	23.18%	27.92%	20.38%	17.90%	16.16%
NASDAQ Composite (Price)	0.25%	7.54%	20.56%	27.37%	28.45%	23.89%	19.48%
Russell 1000	-1.34%	5.50%	21.53%	26.67%	20.65%	17.93%	16.18%
Russell 1000 Growth	0.61%	9.33%	24.95%	30.70%	29.21%	25.10%	19.50%
Russell 1000 Value	-3.52%	1.37%	17.73%	22.25%	11.45%	10.36%	12.50%
Russell Mid Cap	-3.48%	2.26%	17.77%	23.29%	17.49%	14.44%	14.43%
Russell 2500	-4.17%	0.53%	14.43%	23.14%	16.03%	13.46%	13.80%
Russell 2000	-4.17%	-0.09%	12.31%	22.03%	14.22%	12.14%	13.06%
Russell 2000 Growth	-4.88%	-0.43%	2.38%	11.95%	16.08%	14.74%	14.06%
Russell 2000 Value	-3.42%	0.27%	23.24%	33.01%	11.54%	9.08%	11.76%
Non-U.S. Equity Indices							
MSCI World	-2.16%	3.41%	17.30%	22.31%	17.49%	15.22%	12.84%
MSCI ACWI	-2.38%	2.63%	14.42%	19.78%	16.53%	14.57%	11.98%
MSCI ACWI Ex-U.S.	-4.49%	-2.19%	3.97%	9.62%	10.46%	9.79%	7.22%
MSCI EAFE	-4.64%	-2.27%	6.32%	11.28%	10.35%	9.71%	7.89%
MSCI EAFE Growth	-3.38%	-0.21%	6.95%	12.18%	15.78%	13.54%	9.87%
MSCI EAFE Value	-6.00%	-4.46%	5.30%	9.98%	4.64%	5.69%	5.74%
MSCI Europe	-5.14%	-0.83%	9.72%	14.90%	11.37%	10.51%	7.96%
MSCI Japan	-2.46%	-5.74%	0.12%	4.27%	8.84%	8.69%	8.55%
MSCI AC Asia	-3.36%	-3.74%	-3.74%	1.88%	10.00%	9.89%	8.41%
MSCI EAFE Small Cap	-5.58%	-4.08%	5.84%	13.09%	11.90%	11.13%	10.50%
MSCI ACWI Ex-U.S. Small Cap	-4.94%	-3.42%	8.72%	16.36%	13.17%	11.17%	9.21%
MSCI Emerging Markets	-4.07%	-3.11%	-4.07%	3.03%	9.66%	9.91%	5.54%
MSCI EM Asia	-3.63%	-2.40%	-6.22%	0.44%	11.87%	11.62%	8.33%
MSCI China	-5.97%	-3.00%	-19.09%	-16.85%	6.82%	9.31%	7.99%
MSCI EM Eastern Europe	-10.62%	-6.95%	19.33%	31.24%	11.98%	12.74%	4.07%
MSCI EM Latin America	-2.92%	-8.04%	-12.99%	-2.59%	-4.16%	0.83%	-2.59%
MSCI EM Small Cap	-2.92%	-2.68%	14.40%	23.30%	14.71%	10.92%	7.19%
MSCI Frontier Markets	-4.59%	-0.75%	18.31%	25.08%	11.37%	10.15%	7.42%
Hedge Fund Indices							
IQ Hedge Long/Short	-2.24%	0.49%	5.17%	8.56%	9.64%	7.27%	--
IQ Hedge Multi-Strategy	-1.52%	-0.55%	-0.53%	1.49%	4.38%	3.90%	3.50%
Real Assets Indices							
FTSE NAREIT Composite	-1.23%	5.61%	28.21%	31.65%	12.55%	11.08%	11.43%
Alerian MLP	-7.51%	-2.90%	35.35%	38.75%	-2.31%	-2.55%	-0.05%
Bloomberg Commodity	-7.31%	-4.92%	22.78%	28.89%	6.05%	3.31%	-3.56%
S&P Global Infrastructure	-5.34%	-1.92%	4.92%	8.05%	6.76%	7.03%	7.08%
Other							
Oil Price Brent Crude	-16.37%	-10.12	36.24%	48.29%	6.33%	6.93%	-4.41%
CBOE Market Volitility (VIX)	41.21%	1.77%	0.92%	11.62%	8.31%	11.49%	-1.89%

Source: Morningstar

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