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Investment Insights Quarterly

From The Desk of Bill Hornbarger, Chief Investment Officer

January 2022

Predictions for 2022

As the calendar turns to 2022, investors are left wondering what happens next. As every market participant knows, past performance is no guarantee of future results, and after three calendar years of strong gains for the domestic equity markets and almost two years of a global pandemic, everyone is eager to know what's next. Returns over any 12-month period are very difficult – if not impossible – to predict, but looking over the longer-term (seven to 10 years), an environment featuring low starting bond yields, moderating growth, and elevated valuations across most asset classes could weigh on portfolio returns. We are currently updating our Capital Market Assumptions and will publish them soon, and these projected longer-term asset class returns are an important input in our asset allocation process and help shape our thoughts on the markets.

With that in mind, the Benjamin F. Edwards Investment Strategy Committee recently went through the exercise of making "predictions" of events that individual members believe there is at least a 50% chance of happening over calendar year 2022. These predictions ranged in category from the markets and economy to politics and sports, and a few were tongue in cheek. We then compiled those into a list of the predictions that appeared on the most lists.

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Prior to making these predictions, a consensus did form around events that we place a high probability of happening in 2022 and beyond. These include:

- The Fed and Fed activity will be a major focus of the markets. Recent guidance from the Fed in speeches and press releases has indicated that the Fed's own view is now closely aligned with market participants who had been looking for higher interest rates sooner than the Fed. The futures markets are currently priced for three and potentially four interest rate increases in the target Fed funds rate in 2022, similar to the most recent Fed "dot plot." Those increases are highly unlikely to begin prior to the end of the Fed's tapering program, but look for an end to quantitative easing and a higher Fed funds rate in the first half of the year.
- As monetary policy changes, equity market leadership will also likely change.
- The popular domestic equity indices have posted three consecutive years of positive returns, a fourth consecutive year (last achieved in 1999) could be challenging as Fed policy becomes less of a tailwind.
- Inflation could stay elevated from the levels of recent years but will moderate as supply chains are repaired and Covid recedes. Inflation rates will likely stay above Treasury yields in 2022.
- Core fixed income will continue to face headwinds from low and rising interest rates.

In terms of recurring themes that appeared on multiple lists, they were predominantly in two categories, markets and politics (please note that any political based predictions are not an endorsement of any party, position, or person, rather a belief that something has a higher-than-average probability of happening). A few items that were more widely believed to have a 50% or greater probability included:

- The S&P 500 will have at least a 10% drawdown during 2022 – Corrections (defined as at least a 10% decline) happen more frequently than many investors think. Data back to 1928 suggests that corrections happen about every 19 months. Prior to 2020's bear market, the S&P 500 suffered two 10% declines in 2018 and six in the years between the 2007 and 2020 bear markets. Corrections are hard to avoid, and history shows the value in staying invested through them as exemplified by the sharp gains from the March 2020 bear market lows, even as the path of the pandemic was unknown.
- Value outperforms growth during 2022 – Large cap growth has outperformed large cap value persistently since the 2009 lows following the Global Financial Crisis, to the point where many investors have questioned if value is dead. This dramatic outperformance has resulted in a valuation gap between the two styles at relatively extreme levels. That gap, coupled with the prospect of higher interest rates, gives us some confidence in our position. Having said that, our guidance has always been that a well-diversified portfolio with a strategic time horizon should be exposed to both growth and value styles.
- The 10-year Treasury climbs above 2.25% this year – Higher inflation coupled with shifting monetary policy has historically been a recipe for higher yields. The Fed is also tapering and will ultimately not be buying Treasuries in the conduct of extraordinary monetary policy. Many investors might ask why isn't the forecast for even higher yields? That is certainly a possibility, but global sovereign benchmark yields remain low relative to the United States, with countries like Germany and Switzerland trading with negative yields. If the gap between domestic and international yields widens too much, global investors would likely allocate more to U.S. bonds, biasing their yields lower.
- International (developed and emerging) equities outperform U.S. equities in 2022.
- From the world of politics, the two developments that were most frequently mentioned included a Republican sweep in the mid-terms and President Biden having the opportunity to nominate a new Supreme Court

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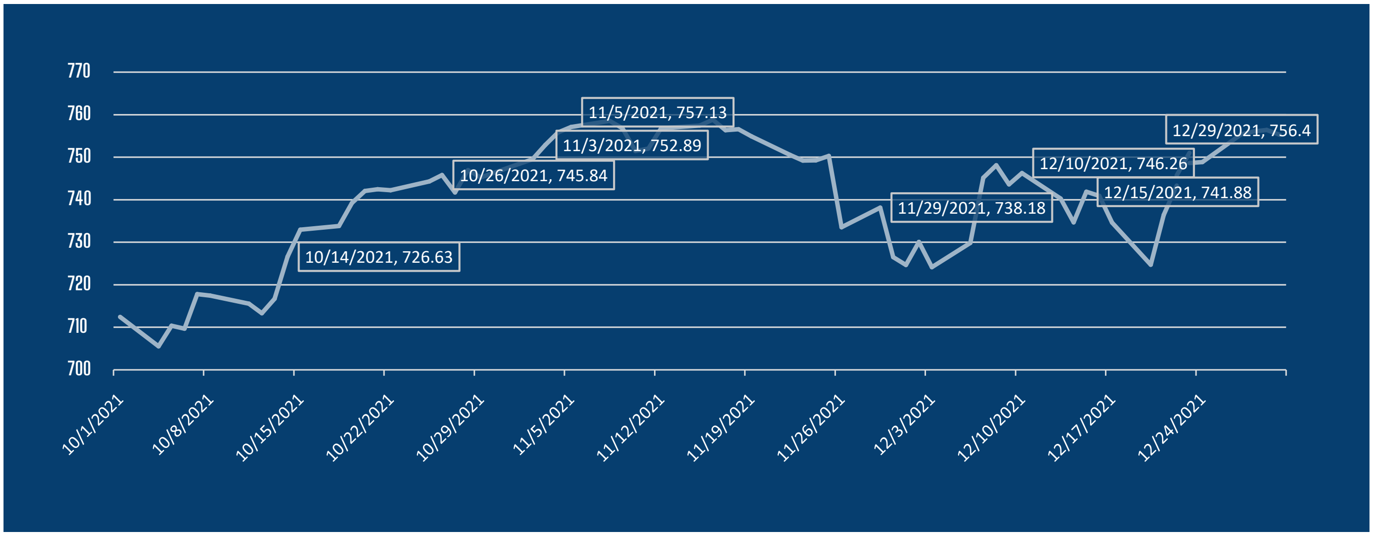
justice prior to the November mid-term elections. As a point of reference, since 1933 (per Strategas Research Partners) the highest returning partisan control combination for the S&P 500 has been a Democratic Senate, Republican House, and Democratic President.

In closing, predicting calendar year returns for the markets is relatively impossible to do on a consistent basis. However, the themes of the Fed beginning to raise rates, moderating economic growth, inflation, and current valuations combined with the market's history does give us some degree of confidence that many of the aforementioned predictions will manifest themselves to some degree. And while these are interesting things to note, our guidance for longer-term focused investors remains unchanged: hold a diversified portfolio, be resistant to panic and euphoria, actively manage risk through disciplined rebalancing, and align your portfolio with your individual goals.

Key Q4 Dates

- October 14 – The debt limit is increased, averting a potential government shutdown
- October 26 – WTI crude breaches $80/barrel for the first time in seven years
- November 3 – Federal Open Market Committee (FOMC) announces plans to begin tapering its asset purchases
- November 6 – Congress passes the Bipartisan Infrastructure Deal (Infrastructure Investment and Jobs Act)
- November 29 – First Omicron case is reported in the United States
- December 10 – November reported consumer price inflation (CPI) surges by 6.8%, the fastest pace since 1982
- December 15 – FOMC accelerates the pace of its tapering program
- December 29 – The S&P 500 closes at a record high for the 70th time in 2021, second to 1995's 77 record closes

Global Stock Market
MSCI ACWI in USD



Source: Bloomberg

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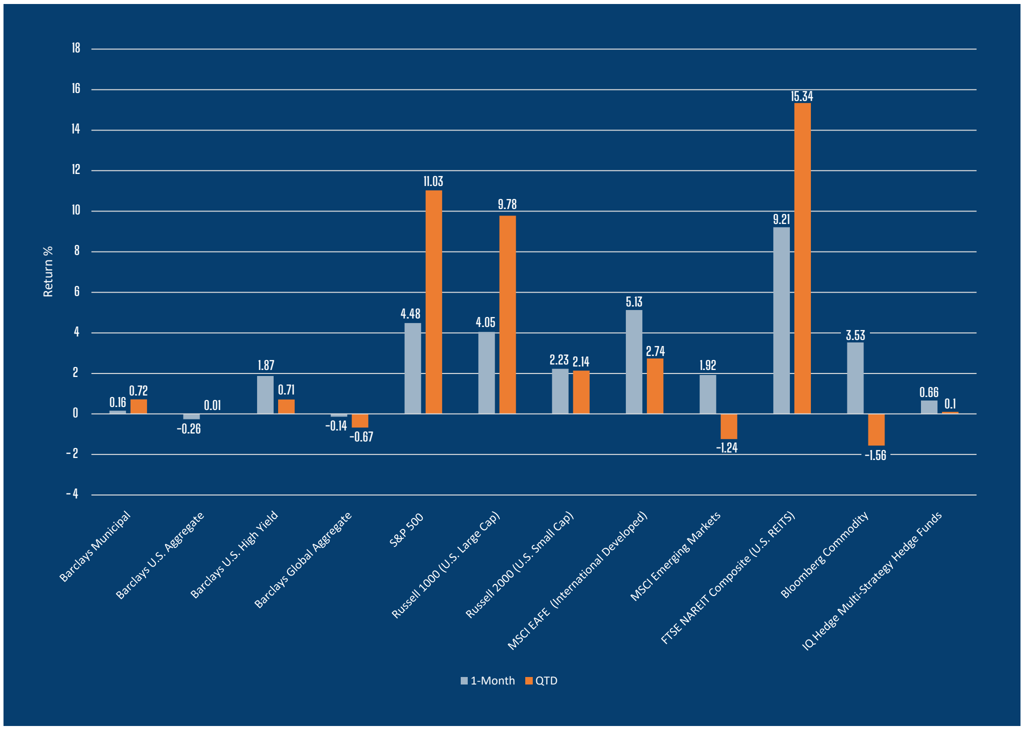
ASSET CLASS PERFORMANCE

Asset Class Returns
Q4 2021



Source: Conway

Fixed Income

- Treasury yields were rangebound to end the year, and this led to slight gains in core fixed income and better returns for municipals.
- Credit spreads tightened in December with solid gains posted in investment grade, high yield, and bank loans.
- Bonds outside the U.S. underperformed as global yields generally were higher.

Equities

- Global equities ended the year on a strong note, led by a resurgence of value stocks.
- Large cap stocks outperformed small cap stocks in the U.S.
- Large cap growth beat large cap value in 2021, but small cap value smashed small cap growth for the year.
- Non-U.S. equities rebounded sharply last month, led by strong returns from Europe.
- Similar to the U.S., value stocks outperformed growth stocks, and large caps beat small caps.
- U.S. dollar weakness boosted EAFE returns by 81 basis points, but currency weakness in emerging markets cost investors about 40 bps of performance in December.

Alternatives

- Real estate was the second-best performing sector of the S&P 500 for both the quarter and the year.
- The Bloomberg Commodity Index posted a negative return in Q4 but ended the year with a 27% gain. Energy posted strong gains for the year, and gold averaged almost $1,800/ounce in 2021.

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Fiscal and Monetary Policy Highlights

Unemployment Rate	2022	2023	2024
September 2021 projections	3.8%	3.5%	3.5%
December 2021 projections	3.5%	3.5%	3.5%

Inflation (Personal Consumption Expenditures)	2022	2023	2024
September 2021 projections	2.2%	2.2%	2.1%
December 2021 projections	2.6%	2.3%	2.1%

- The Fed met twice in Q4 and left rates unchanged at both meetings.
- The Fed began its long-anticipated tapering program in November and accelerated it in December. The Fed is on track to end tapering in March of 2022 under the current schedule.
- Beginning in September, the FOMC stated that it didn't expect to raise rates until the economy had reached maximum employment and inflation was at least 2% and on pace to exceed that level for a period.
- In December, the Fed indicated the inflation threshold had been met.
- In the latest projection materials, released mid-December, the Fed revised its inflation forecast higher and the unemployment rate lower.
- The Fed has also revised its monetary policy forecast (the dot plot) and now forecasts three interest rate increases in 2022.
- Congress increased the debt limit and passed a $1.2 trillion Bipartisan Infrastructure Deal (Infrastructure Investment and Jobs Act).

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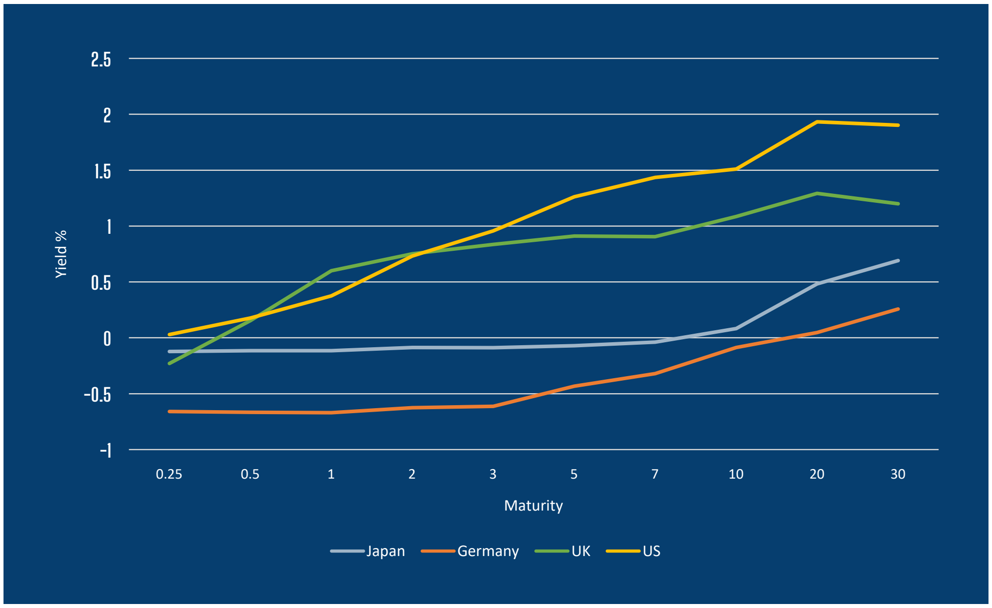
Government Bond Curves

At the end of Q4, $11.3 trillion in global sovereign debt traded with negative yields. That represented a decline of more than $2 trillion in the quarter as higher inflation and central bank activity and rhetoric resulted in yields creeping higher.

Government Bond Curves

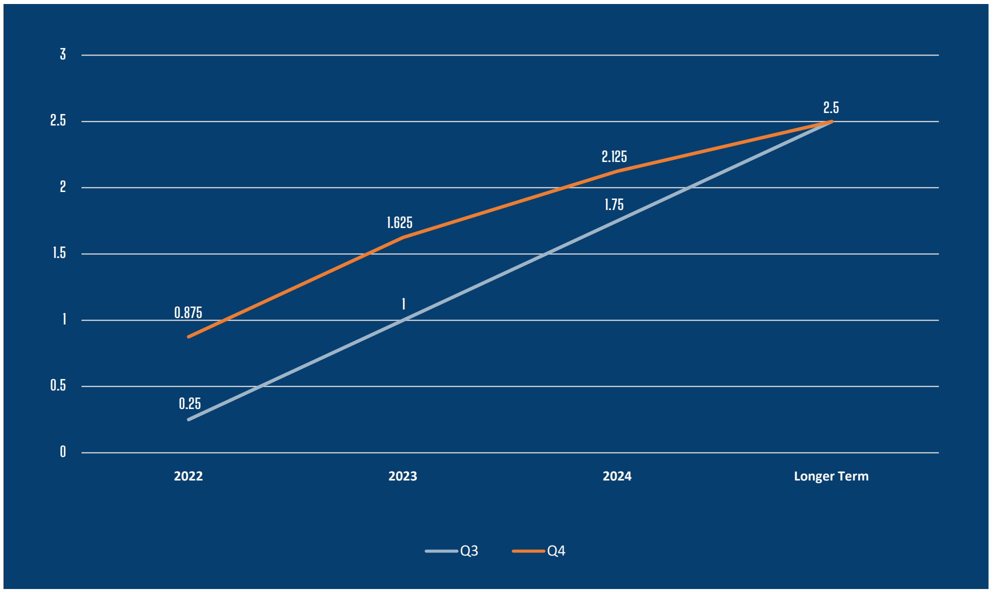


Source: Bloomberg

Monetary Policy Expectations

In addition to the Fed announcing and accelerating its tapering program, policymakers also revised their forecast on the pace of interest rate increases. By the end of Q4, the consensus was for three increases in 2022, up from a consensus of one increase at the end of Q3.

Median of FOMC Dots Data Projection
Year End Targets
Q3 vs. Q4 2021



Source: Bloomberg

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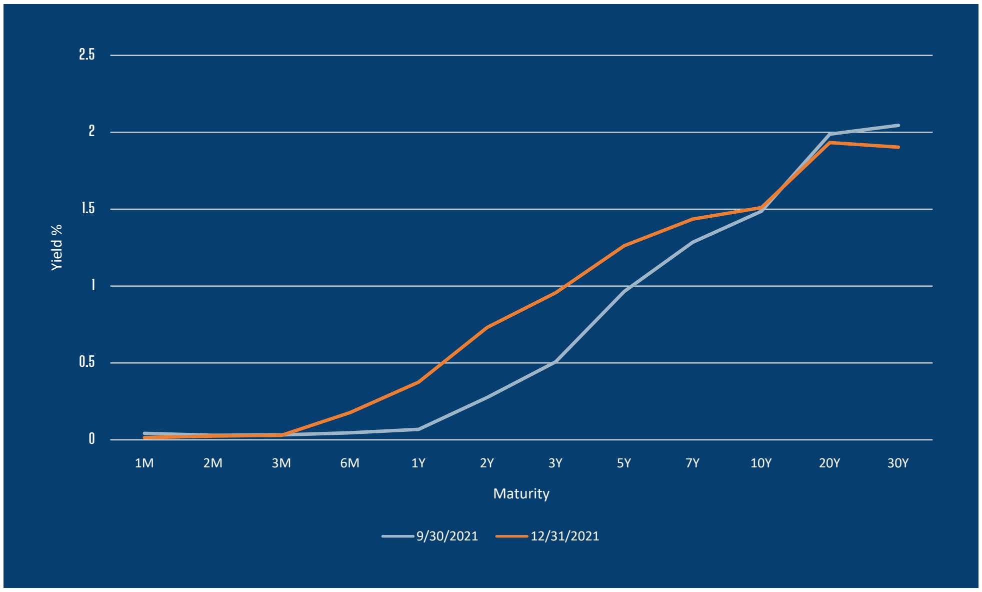
U.S. Treasury Curve

The yield curve between 2-and 10-years flattened noticeably during the quarter. Short- and intermediate-term coupon bonds saw yields rise on beliefs that the Fed will be increasing rates multiple times in 2022. Longer-term maturities remain well bid on positive yield differentials versus other developed markets.

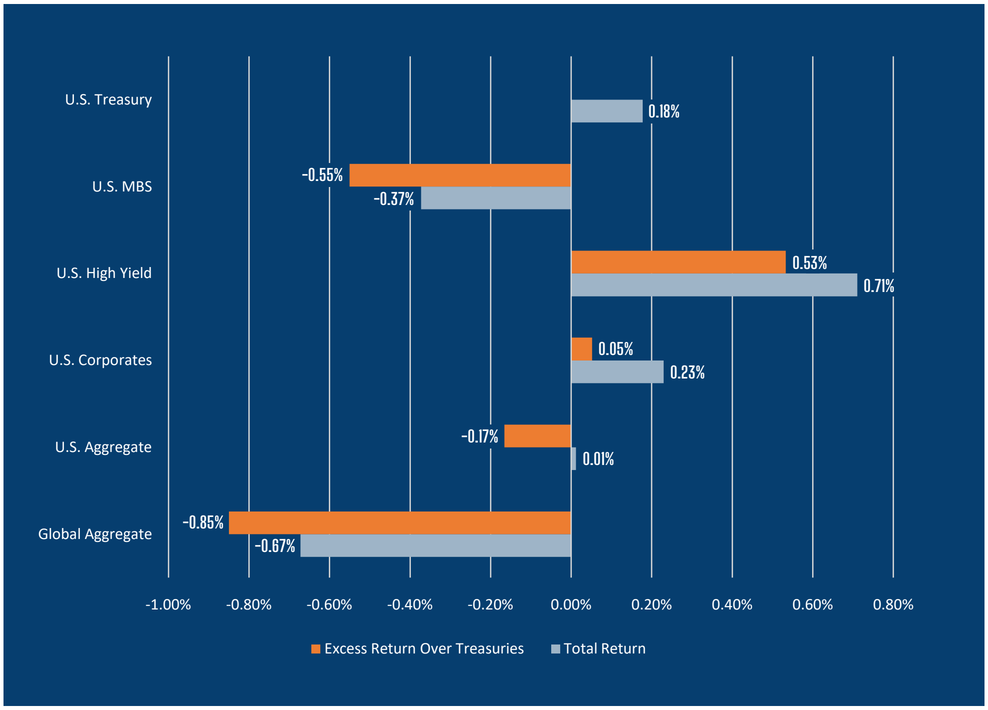
Treasury Yield Curve



Source: Bloomberg

Fixed Income Performance (Q4)

Credit, both high yield and investment grade, outperformed in Q4. The Treasury index managed a slight gain as longer maturity yields declined. Global developed market bonds were hurt by slightly higher market yields.



Source: Bloomberg

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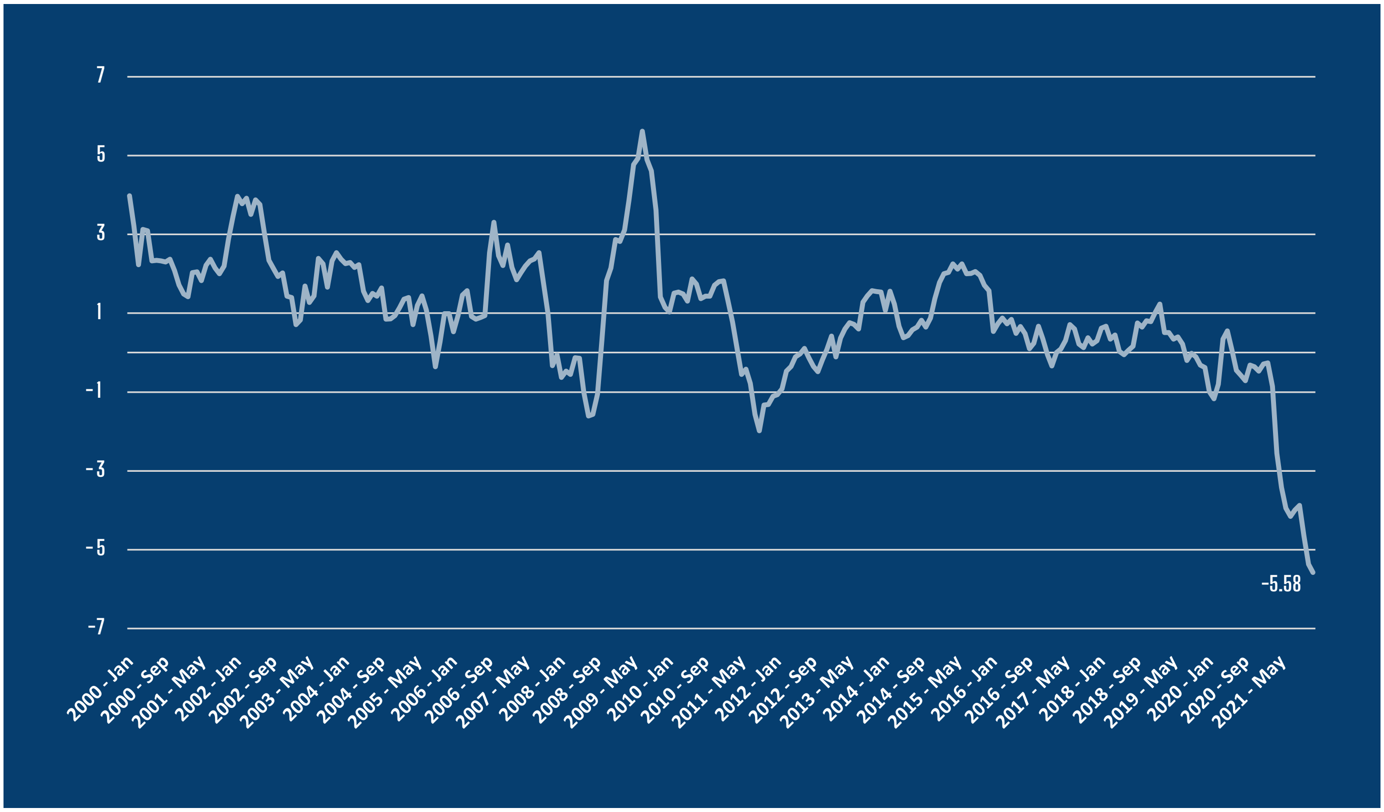
Quantitative Easing

The increase in inflation, coupled with low bond yields as a result of the Fed, has resulted in record low real yields. The real 10-year Treasury yield is in excess of negative 5.5% as we enter 2022.

Real 10-Year Treasury Yield

10-Year Treasury less CPI (yoy%)



Source: Haver

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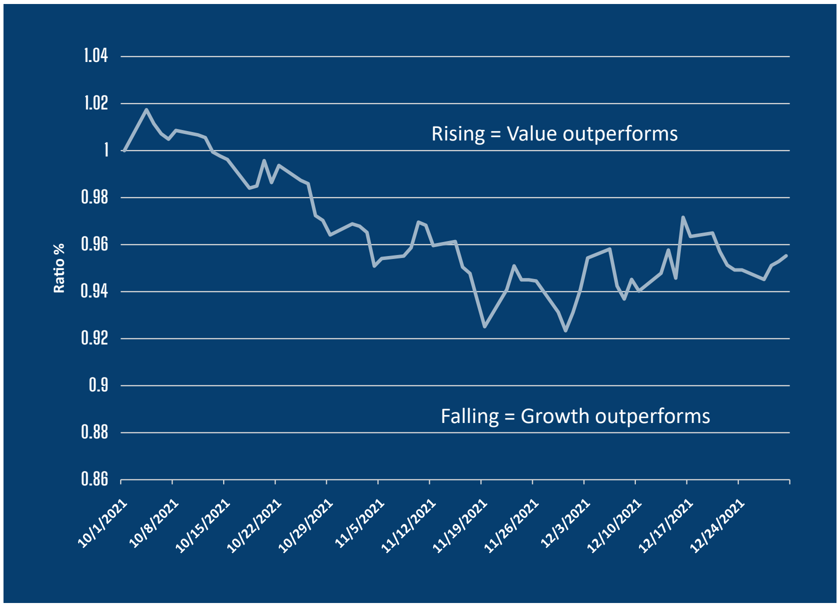
Equity – Value vs. Growth

Large cap growth beat large cap value for both the fourth quarter and the full year. However, as Fed rhetoric changed, value led by 400+ basis points in the last month of the year.

Large-Cap Value/Large-Cap Growth – Q4 2021

Russell 1000 Value/Russell 1000 Growth



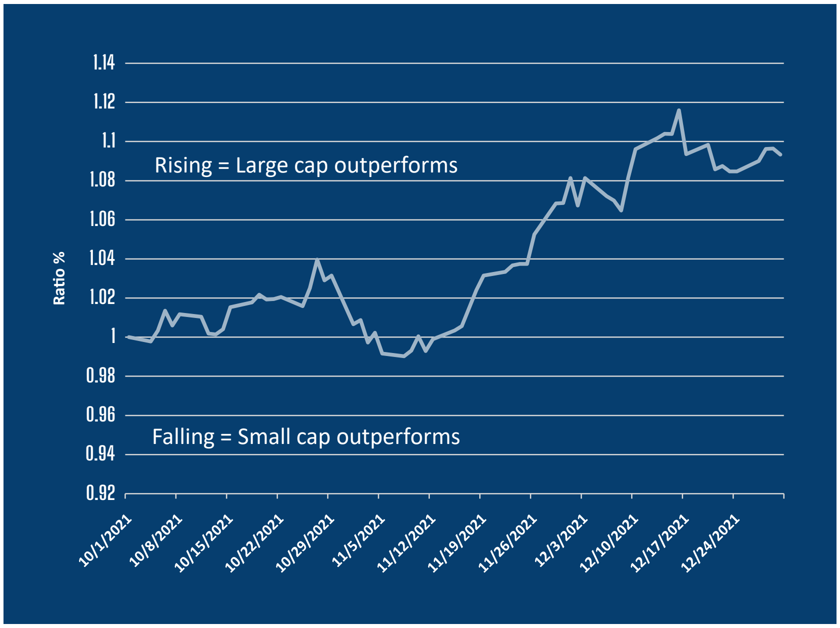
Source: Bloomberg

Equity – Large vs. Small

Large cap outperformed small cap all year, and the trend accelerated into year end. For the year, the S&P 500 earned almost twice what the Russell 2000 returned.

Large Cap/Small Cap – Q4 2021

S&P 500/Russell 2000



Source: Bloomberg

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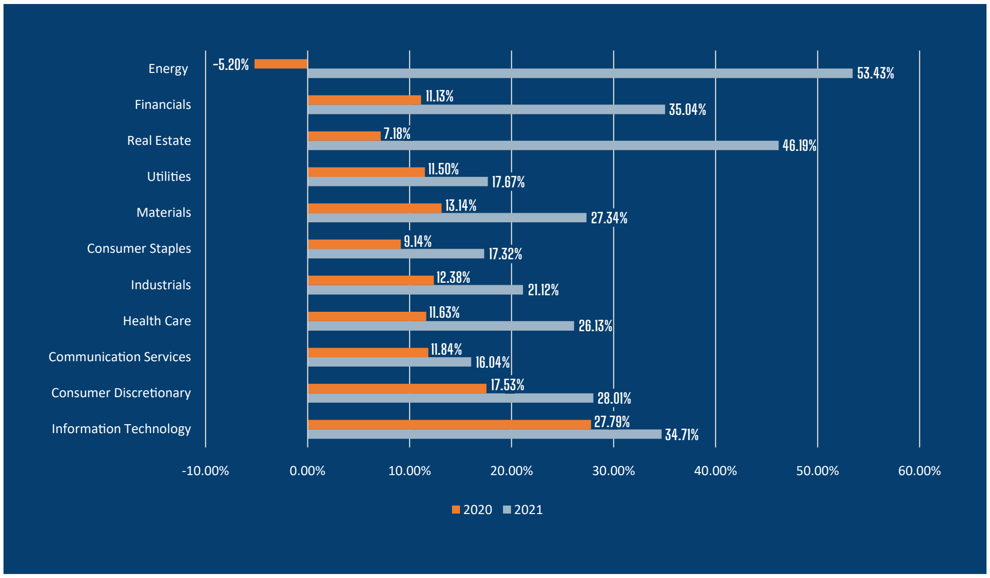
U.S. Equities – Return by Sector

The S&P 500 posted strong gains for the third consecutive year. The period ending December 1999 was the last time the S&P posted four consecutive positive years. Looking through the headline numbers, 2020's poorest performing sectors (energy, real estate, financials) were 2021's leaders.

Sector Returns
2020 vs. 2021

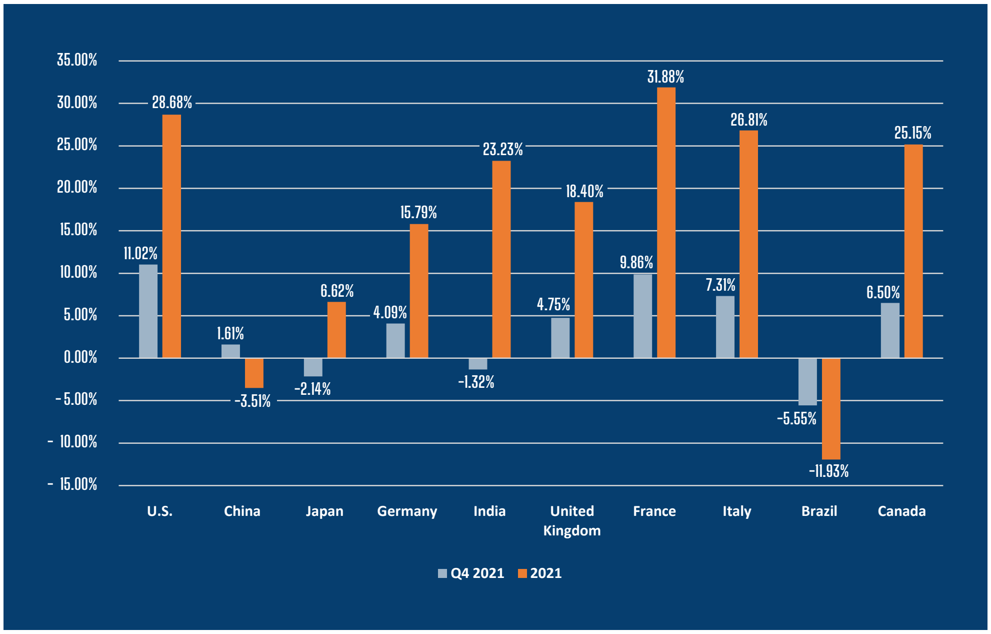


Source: S&P

Country Total Returns (%) – 10 Largest Economies

Returns for Q4 were positive across the board, led by emerging economies. Returns in developed Europe for the quarter and the year lagged, as those countries generally struggled to deal with the virus and the resulting recessions.

Country Total Returns
Local Currency



Source: Bloomberg

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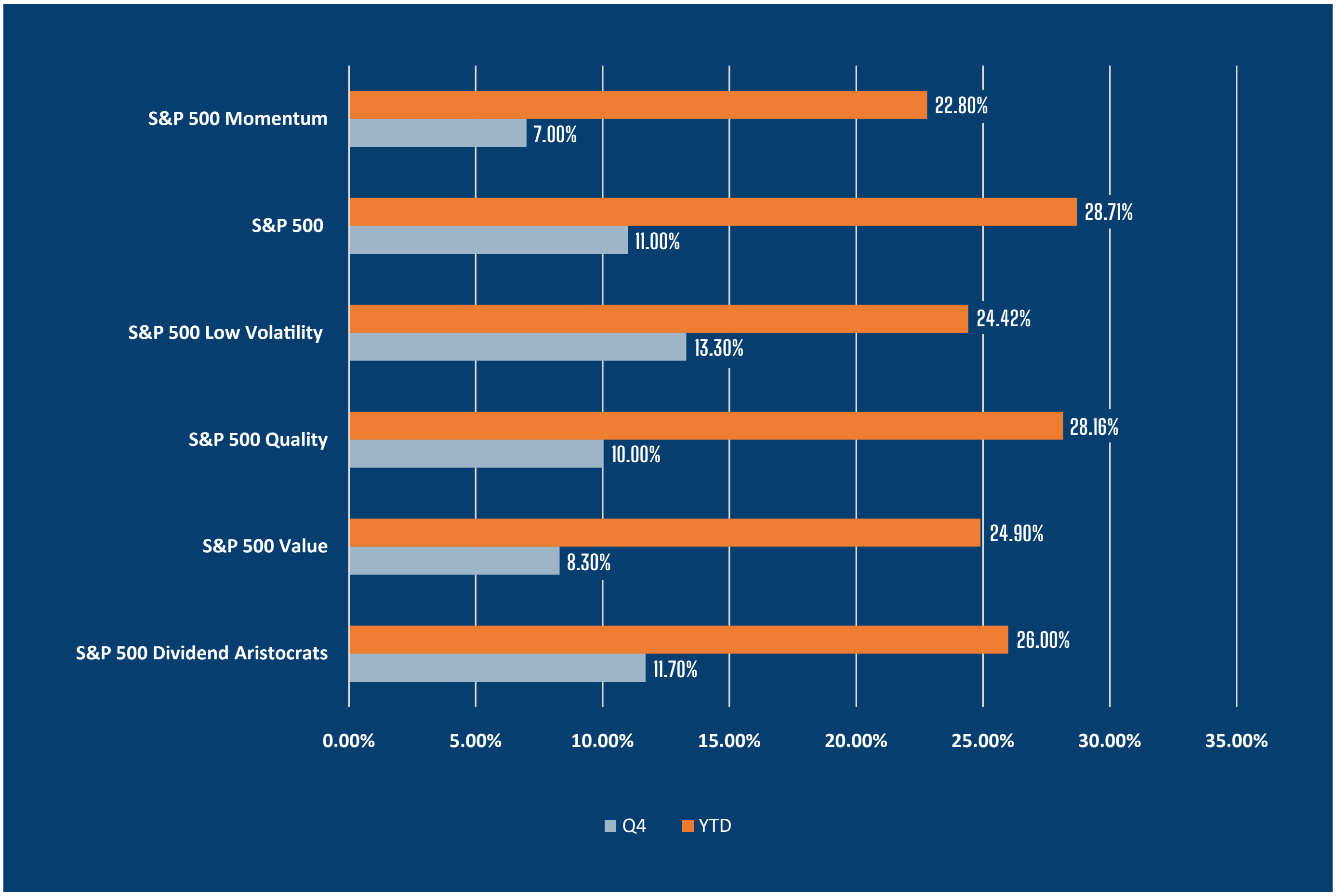
U.S. Equity Factors – Total Return Q4

More defensive factors (dividends and low volatility) led performance in Q4. All of the core factors posted strong returns for the calendar year, with quality being the leader in 2021.

Total Return: Core Factors
Q4 and YTD



Source: S&P

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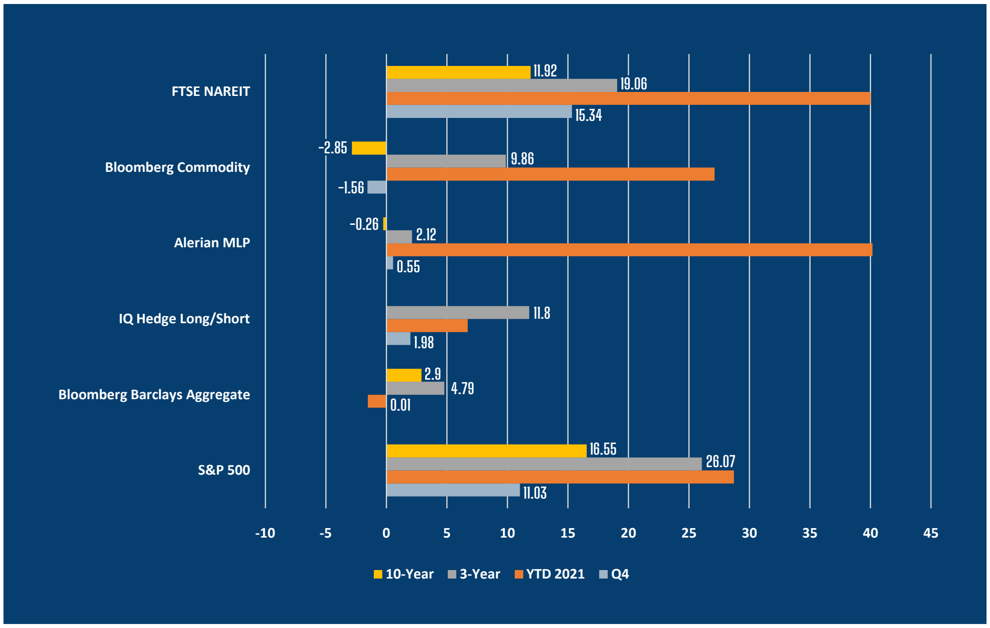
Alternative Returns

While longer term performance remains uninspiring relative to equities, many alternative asset classes and strategies have provided strong recent performance, particularly relative to core fixed income.

Periodic Returns



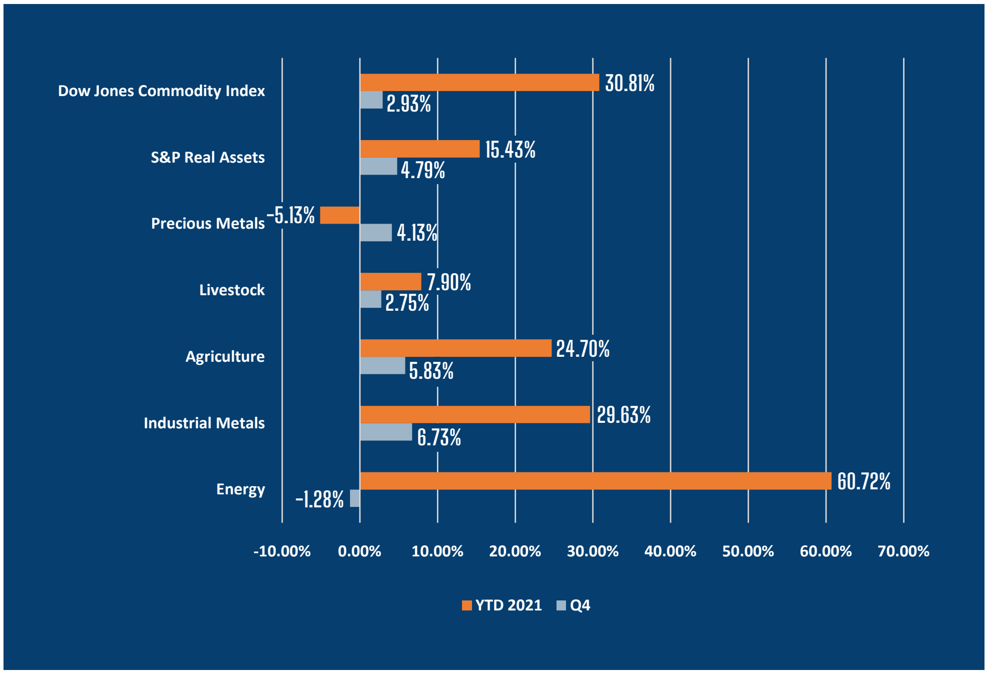
Source: Conway

Commodities

Despite very strong recent performance by many individual sectors/ constituents, the Dow Jones Commodity Index has posted a negative return for the trailing ten-year period. Concerns over monetary/ fiscal policy and inflation boosted commodities and real assets in 2021.

Commodity Performance

Q4 vs. YTD 2021



Source: S&P

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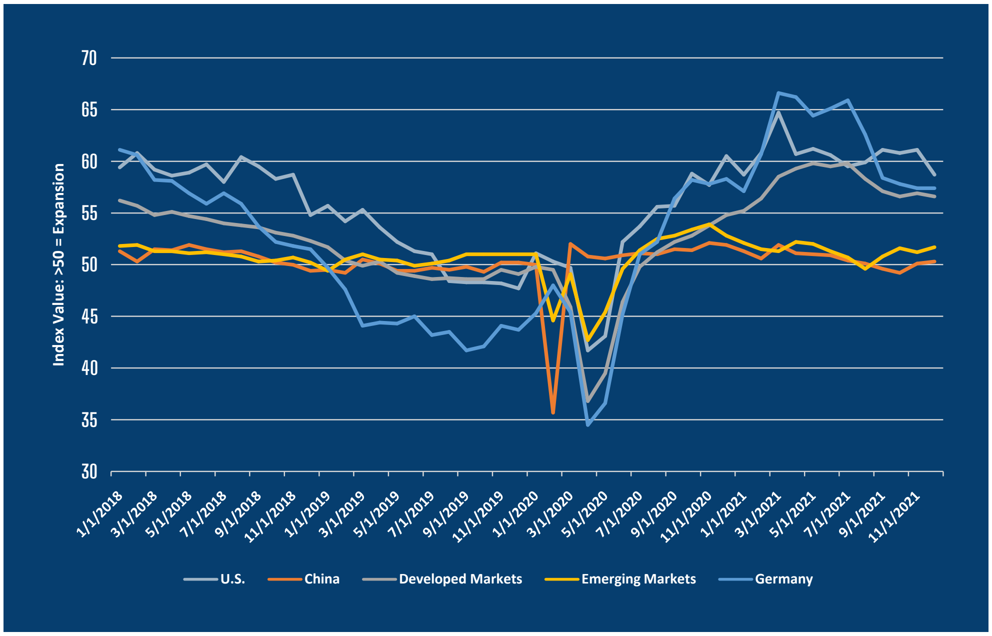
PMI Composites

The Purchasing Managers Index (PMI) is a survey-based measure of the prevailing direction of trends in the manufacturing sector. Readings more than 50 equal expansion while less than 50 indicates contraction. By this measure, the global economy looks generally strong while China continues to struggle on a relative basis.

Global Manufacturing Surveys

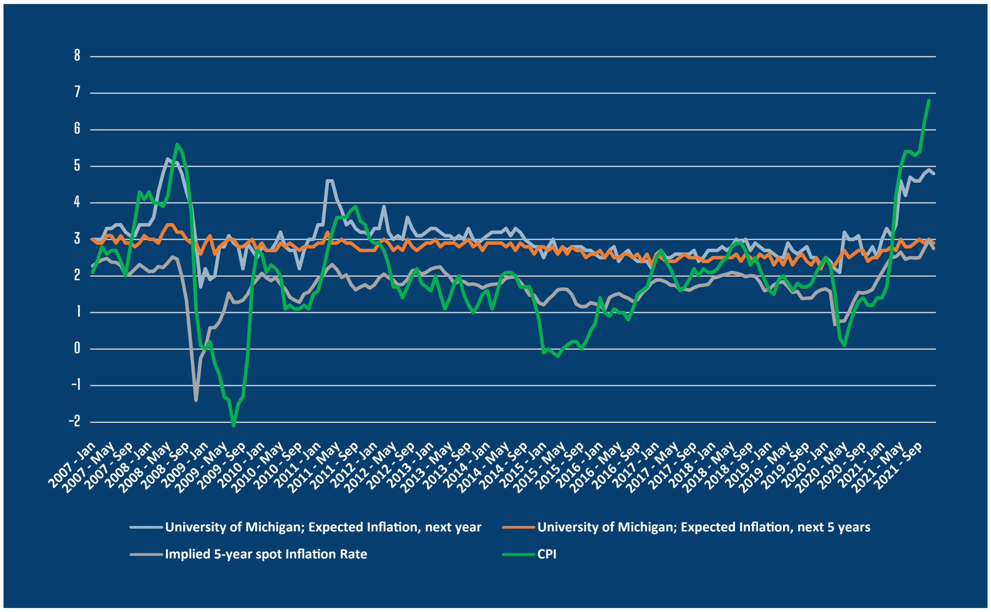


Source: Bloomberg, Haver

Inflation Expectations

Recent increases in inflation measures have led to higher inflation expectations, particularly in the shorter term. This is reflected in both survey-based as well as market-based data. Inflation expectations remain below current inflation readings.

Market- and Survey-Based Inflation Expecations (%)



Source: Haver

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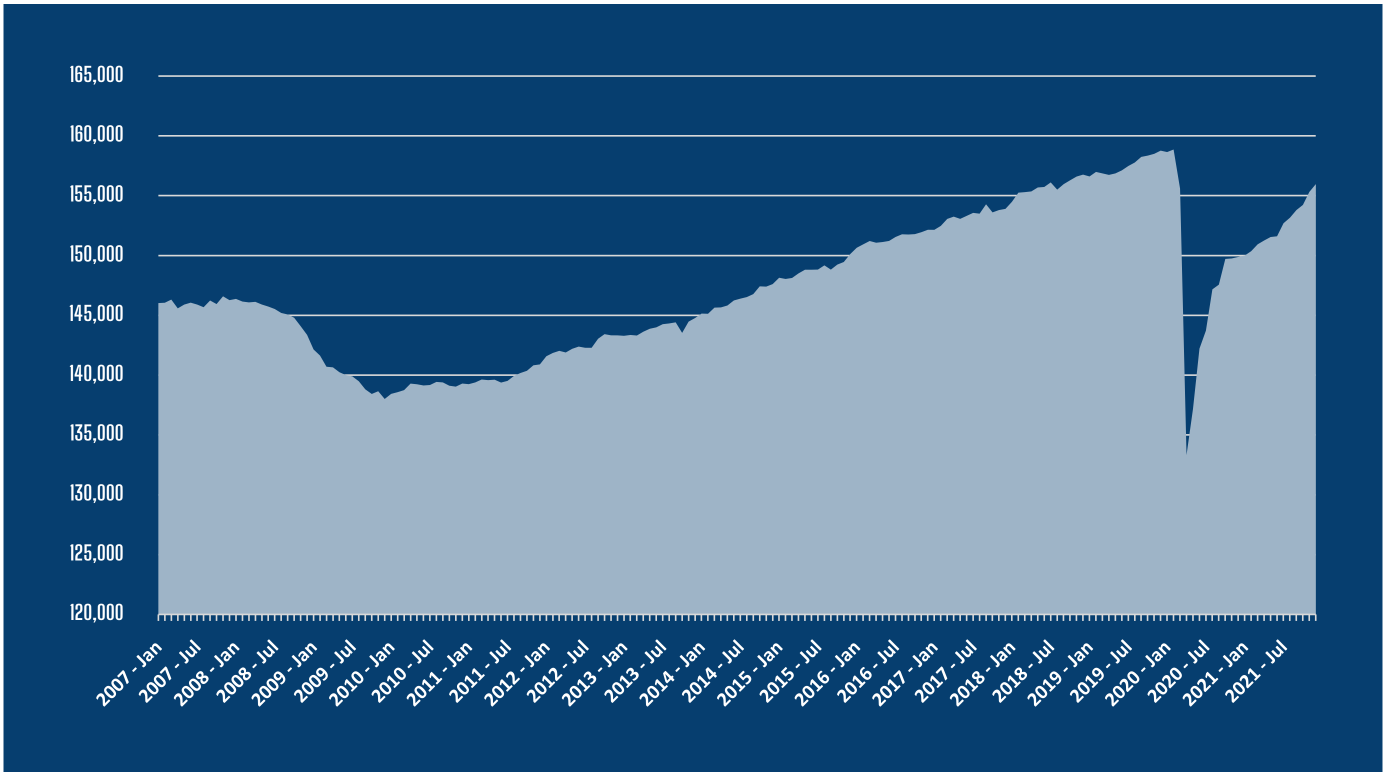
Employment

The economy added more than 2.1 million jobs in Q4 but remains almost 3 million short of pre-pandemic levels of employment. Retirements have increased, buoyed by strong asset prices.

Civilian Employment: 16 Years & Over
Thousands



Source: Bloomberg

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December 31, 2021	MTD	QTD	YTD	1-Year	3-Year	5-Year	10-Year
Fixed Income Indices							
Barclays U.S. Treasury Bill 1-3 Month	0.00%	0.01%	0.04%	0.04%	0.93%	1.08%	0.58%
Barclays Municipal	0.16%	0.72%	1.52%	1.52%	4.73%	4.17%	3.72%
BBgBarc U.S. Govt/Credit Intermediate	-0.15%	-0.56%	-0.47%	-0.47%	2.28%	1.85%	1.39%
Barclays U.S. Aggregate	-0.26%	0.01%	-1.54%	-1.54%	4.79%	3.57%	2.90%
Barclays U.S. High Yield	1.87%	0.71%	5.28%	5.28%	8.83%	6.30%	6.83%
S&P/LSTA Leveraged Loan	0.02%	0.02%	0.02%	5.20%	5.62%	4.27%	4.69%
Barclays Global Aggregate	-0.14%	-0.67%	-4.71%	-4.71%	3.59%	3.36%	1.77%
JPM GBI EM Global Diversified	1.56%	-2.53%	-8.75%	-8.75%	2.07%	2.82%	0.74%
U.S. Equity Indices							
DJ Industrial Average	5.53%	7.87%	20.95%	20.95%	18.49%	15.51%	14.21%
S&P 500	4.48%	11.03%	28.71%	28.71%	26.07%	18.47%	16.55%
NASDAQ Composite (Price)	0.69%	8.28%	21.39%	21.39%	33.10%	23.79%	19.63%
Russell 1000	4.05%	9.78%	26.45%	26.45%	26.21%	18.43%	16.54%
Russell 1000 Growth	2.11%	11.64%	27.60%	27.60%	34.08%	25.32%	19.79%
Russell 1000 Value	6.31%	7.77%	25.16%	25.16%	17.64%	11.16%	12.97%
Russell Mid Cap	4.08%	6.44%	22.58%	22.58%	23.29%	15.10%	14.91%
Russell 2500	3.28%	3.82%	18.18%	18.18%	21.91%	13.75%	14.15%
Russell 2000	2.23%	2.14%	14.82%	14.82%	20.02%	12.02%	13.23%
Russell 2000 Growth	0.44%	0.01%	2.83%	2.83%	21.17%	14.53%	14.14%
Russell 2000 Value	4.08%	4.36%	28.27%	28.27%	17.99%	9.07%	12.03%
Non-U.S. Equity Indices							
MSCI World	4.30%	7.86%	22.35%	22.35%	22.32%	15.64%	13.32%
MSCI ACWI	4.03%	6.77%	19.04%	19.04%	20.97%	14.97%	12.44%
MSCI ACWI Ex-U.S.	4.16%	1.88%	8.29%	8.29%	13.70%	10.12%	7.78%
MSCI EAFE	5.13%	2.74%	11.78%	11.78%	14.08%	10.07%	8.53%
MSCI EAFE Growth	4.33%	4.11%	11.59%	11.59%	19.37%	14.00%	10.48%
MSCI EAFE Value	5.97%	1.25%	11.58%	11.58%	8.47%	5.97%	6.42%
MSCI Europe	6.61%	5.72%	16.97%	16.97%	15.57%	10.79%	8.82%
MSCI Japan	1.91%	-3.94%	2.04%	2.04%	12.08%	8.89%	8.67%
MSCI AC Asia	1.59%	-2.21%	-2.21%	-2.21%	12.25%	10.37%	8.51%
MSCI EAFE Small Cap	4.39%	0.12%	10.48%	10.48%	16.05%	11.45%	11.19%
MSCI ACWI Ex-U.S. Small Cap	4.27%	0.70%	13.36%	13.36%	16.91%	11.63%	9.86%
MSCI Emerging Markets	1.92%	-1.24%	-2.22%	-2.22%	11.33%	10.26%	5.87%
MSCI EM Asia	1.51%	-0.92%	-4.80%	-4.80%	13.62%	12.26%	8.42%
MSCI China	-3.15%	-6.06%	-21.64%	-21.64%	7.91%	9.52%	7.38%
MSCI EM Eastern Europe	-0.57%	-7.49%	18.65%	18.65%	12.68%	10.25%	5.09%
MSCI EM Latin America	6.04%	-2.48%	-7.73%	-7.73%	-2.02%	1.83%	-1.86%
MSCI EM Small Cap	4.27%	1.48%	19.29%	19.29%	16.92%	11.88%	7.78%
MSCI Frontier Markets	1.50%	0.74%	20.09%	20.09%	13.04%	9.88%	7.70%
Hedge Fund Indices							
IQ Hedge Long/Short	1.47%	1.98%	6.72%	6.72%	11.80%	7.35%	--
IQ Hedge Multi-Strategy	0.66%	0.10%	0.13%	0.13%	5.18%	3.87%	3.52%
Real Assets Indices							
FTSE NAREIT Composite	9.21%	15.34%	40.02%	40.02%	19.06%	12.12%	11.92%
Alerian MLP	3.56%	0.55%	40.17%	40.17%	2.12%	-2.70%	-0.26%
Bloomberg Commodity	3.53%	-1.56%	27.11%	27.11%	9.86%	3.66%	-2.85%
S&P Global Infrastructure	6.62%	4.58%	11.87%	11.87%	10.21%	7.79%	7.73%
Other							
Oil Price Brent Crude	10.22%	-0.94%	50.15%	50.15%	13.07%	6.48%	-3.20%
CBOE Market Volitility (VIX)	-25.00%	-23.67%	-24.31%	-24.31%	-12.17%	4.17%	-3.02%

Source: Morningstar

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