Market rallies despite rising inflation and Covid resurgence

Equity markets were strong during the fourth quarter as they climbed the proverbial "wall of worry." During this period, the S&P 500 faced higher than expected inflation, a resurgence in Covid-19 cases and a Federal Reserve getting closer to raising interest rates, and yet the market rallied to new records. This was only the 19th time in the last 30 years that the index had a quarterly total return greater than 10%.

The S&P finished the year up 28.7% on a total return basis, just less than 1% away from the all-time high it set in late December. Putting this strength into perspective, the U.S. stock market grew by $12 trillion in calendar year 2021 alone, reaching a total value of $53 trillion as compared to only $16 trillion of value just a decade ago.

A deeper look into the drivers of the index's performance reveals there was quite a bit of volatility in the market last year. We entered 2021 taking a balanced approach to most client portfolios with exposure to both growth and value stocks. Investors encountered numerous market rotations between these categories and many individual stocks in both groups experienced significant corrections. In light of this environment, we believe our barbell approach served clients well last year. Profits were robust across most sectors.

As we look ahead, we continue to position portfolios for growth, yet we expect volatility to increase to higher, more historical levels, in 2022. Earnings for many S&P 500 companies should be strong, although valuations are likely to contract from elevated levels. Our investment team has built this into our assumptions. We also believe that the Federal Reserve's plan to raise interest rates, as well as the upcoming mid-term elections, both present sources of risk that are capable of generating a more significant correction. Over the last 30 years, stocks have corrected by an average of 14% annually and this is certainly a possibility in 2022.

Figure 1

2021 Performance by Sector

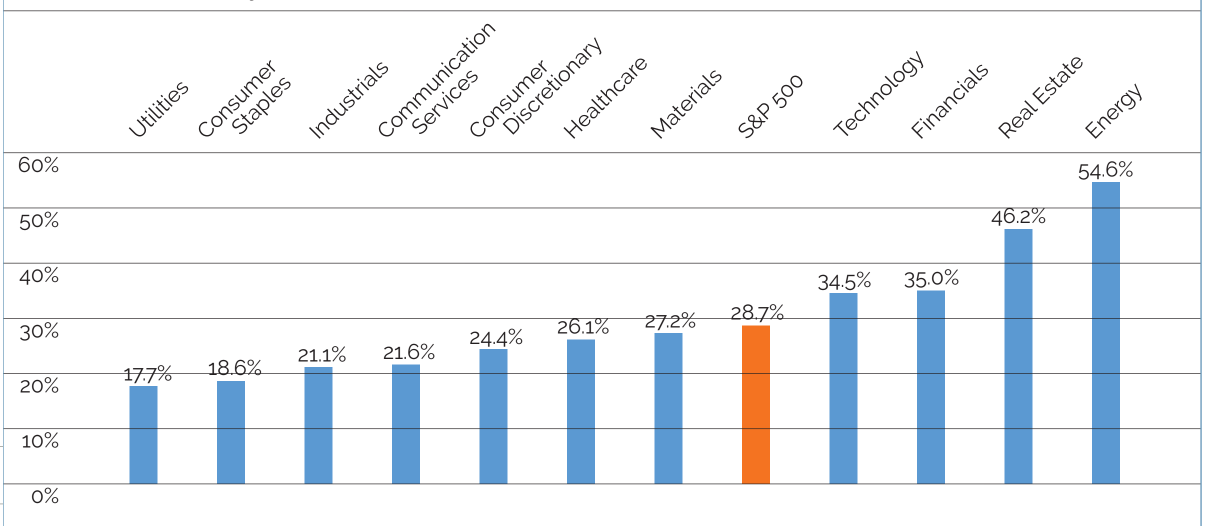

Figure 1 Source: Bloomberg. All performance based on total returns. Data as of 12/31/2021.

The S&P 500 Index gained 11.0% in the fourth quarter to finish the year up 28.7%. As Technology continued its strong run, lagging sectors such as Consumer Staples, Utilities and Materials, saw a bounce back in the period. By year-end, all eleven sectors participated in the growth, posting double digit returns for the year (see Figure 1).

Double digit returns also were realized for most global markets in 2021, with the S&P 500 outperforming by a wide margin. Oil prices bounced back in 2021, in part due to supply chain issues. Surprisingly, despite being a traditional hedge for inflation, gold saw significant underperformance (see Figure 2).

Figure 2

2021 Performance by Category

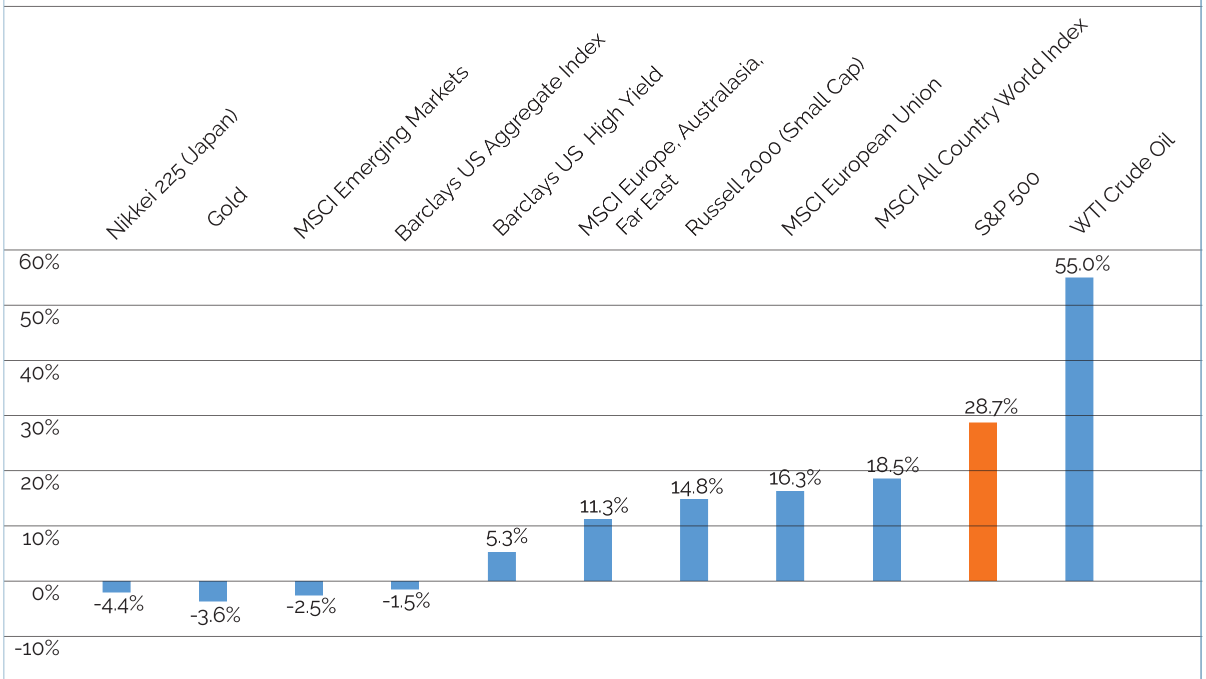

Figure 1 Source: Bloomberg. Data as of 12/31/2021. All performance based on total returns and in U.S. dollars.

2021 in Review

It was another strong year for the financial markets as the economy continued to heal from the pandemic. The domestic economy, as defined by Gross Domestic Product (GDP), is expected to have grown 5.6% in 2021, with the impact of inflation boosting nominal GDP growth to 10.3%. Consumer spending, which represents 70% of our economy, was robust with many participants engaging in revenge spending to make up for lost time. In addition, the consumer benefitted from low unemployment, with new weekly claims in December hitting the lowest level since September of 1969. However, inflation increased at the fastest pace since 1982 driven by shortages in labor, shipping bottlenecks and volatile commodity prices.

As previously indicated, we entered 2021 applying our barbell approach to most client portfolios with exposure to both growth and value stocks. This approach proved to be beneficial as we experienced swift and dramatic rotations in market leadership over the course of the year (see figure 3). In fact, the last 12 months have proven to be an important reminder for why we build diversified portfolios.

In January 2021, we highlighted our additional equity exposure in the industries most effected by the pandemic and/or economic weakness – with many of these investments falling into the "value" category. While growth opportunities led the way in 2020, we expected market participation to keep broadening over the ensuing 12-18 months.

Equity markets surged in the first half of 2021, as gross domestic product (GDP), consumer spending and industrial production all rebounded sharply from the self-imposed recession we experienced in 2020. The value side of the barbell led the way as the market began to price in the end of the pandemic, with many depressed travel, leisure and restaurant focused companies seeing improvements in demand after mass vaccinations.

By the end of the second quarter, our fundamental research identified that we had realized the "value" in some of the recovery names and in turn, we exited some of these positions. This resulted in tilting the barbell back towards growth with additional exposure in the Technology and Communication Services sectors.

Again, this proved to be prudent. Growth companies, primarily in the Technology area, took the baton in the second half of the year to drive the market to record highs. With the S&P 500 achieving 70 record highs in 2021, the highest number since 1995, technology stocks were primary beneficiaries. In fact, the Technology sector saw its weight in the index grow to nearly 30% by year-end.

Figure 3

Growth Stocks vs. Value Stocks

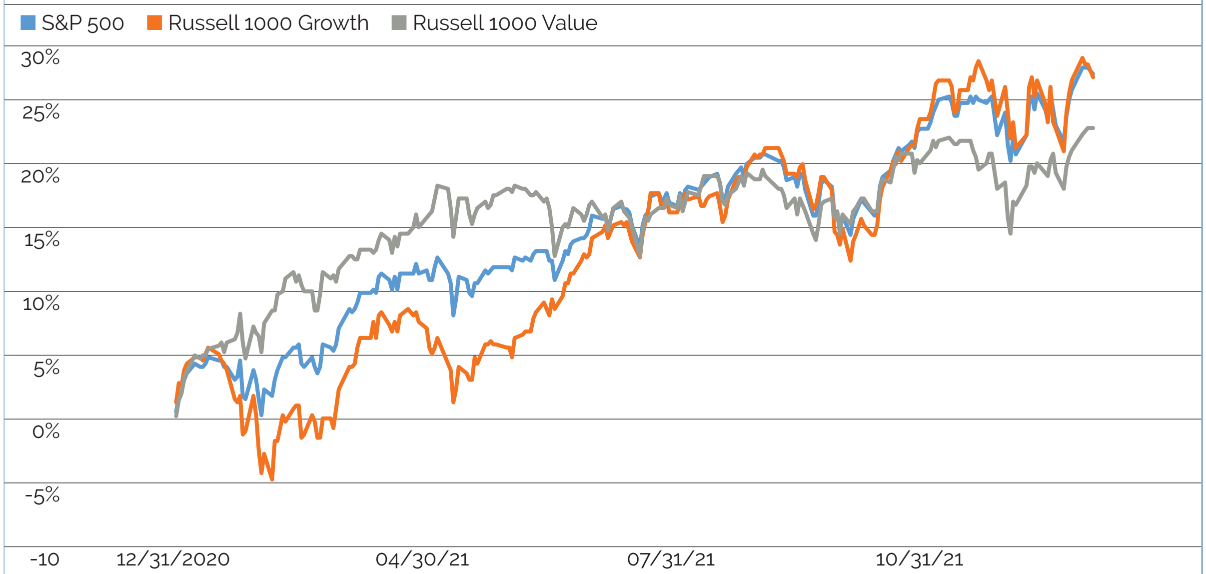

Figure 3 Source: Bloomberg. Data as of 12/31/2021.

Outlook for 2022

As we head into 2022, client portfolios remain positioned for growth. GDP is expected to grow by 3.9% in 2022, driven primarily once again by consumer spending. The Conference Board's latest survey shows that firms are budgeting salary increases of 4% in 2022, creating higher wages that may help boost consumer spending. Unemployment is expected to hit record lows again in 2022, which should also keep consumer confidence at healthy levels.

The global economy should continue to reopen as Covid-19 transitions from a pandemic to an endemic disease, thereby helping to ease some of the supply chain problems the world has been experiencing. Earnings for many S&P 500 companies are forecasted to be strong, although valuations, as mentioned in our overview, are likely to contract from elevated levels.

At the same time, we expect to see more volatility this year. Over the last 30 years, stocks have corrected by an average of 14% annually. Since the market bottomed in March of 2020, the S&P 500 has not experienced a retreat greater than single-digits. Again, as mentioned in our overview, we believe that Federal Reserve interest-rate hikes and the mid-term elections are both sources of risk capable of generating a more significant correction.

Staying Guarded for Possible Volatility

During the height of the pandemic in 2020, the Federal Reserve and Congress acted quickly with enormous stimulus plans equal to 40% of GDP. These programs helped drive the V-shaped economic recovery, record low interest rates, and the 119% return in the S&P 500 since March 23rd of 2020. As we enter 2022, many of the aid programs from Congress have now concluded, while the Federal Reserve is looking to end the emergency measures they put in place.

In our outlook for 2021, we noted that the Federal Reserve was expected to remain accommodative until the economy saw meaningful improvement. Last quarter, GDP surpassed its 2019 peak and in November the Fed responded by announcing a highly anticipated reduction (tapering) in the monthly purchases of Treasury bonds and agency mortgage-backed securities. In December, the Fed announced it would double the purchase pace announced a month earlier, as employment numbers and inflation metrics came in above expectations. This new purchase pace not only implies that tapering will conclude in March 2022, at which point the Fed will no longer purchase bonds for its balance sheet, but also signals short-term rates will increase sooner than expected.

The Fed's dot plot, which is a summary of the Fed members anticipated rate increases, now suggests at least two rate increases in 2022, followed by two to three in 2023, and one or two more in 2024. This would bring the Fed Funds Rate to its target rate of around 2%.

The yield spread measures the difference between the 10-year U.S. Treasury yield and the 2-year U.S. Treasury yield. At the end of 2021, these yields were 1.5% and 0.73% respectively, producing a yield spread of 0.77%. Since a stable, or increasing spread, signals confidence that the economy is expanding as rates move toward the Fed's target, this will be an important indicator to watch as the Fed looks to raise rates over the next three years.

It is also important to note that one trademark of the Powell Fed has been its willingness to adjust its position in response to evolving conditions. With Chairman Powell now nominated and widely expected to be confirmed for a second four-year term, it is likely that the Fed will continue to be flexible, driven by its dual mandate of full employment and stable prices. The ongoing pandemic, wage increases, general inflation expectations, and financial market conditions, are key variables they will want to watch.

In addition to the Fed, another possible source of volatility this year is the mid-term elections. It is too early to focus on specific concerns, but in general U.S. stocks have not performed well during mid-term election years, with volatility usually higher earlier in the year. Again, persistent inflation, and Covid-19 issues along with fiscal spending and geopolitical events, will all be key factors to watch.

Investment Frameworks

Our firm's active management approach is predicated on finding high quality companies that we believe will outperform the S&P 500 over the long-term. The first stage for prospective investments includes a funnel that focuses on quality, which includes characteristics such as under-levered balance sheets, strong returns on incremental invested capital, industry-leading competitive positions, and long growth runways. From there, our research team assesses management quality, which we believe is often underappreciated and key to superior long-term returns.

While there are many different considerations for sector, industry, and company exposure, the research team employs numerous frameworks that are transferable across industries. By developing pattern recognition and repetitively looking for investments that have similar characteristics, we believe that our team can identify trends that the market does not fully appreciate. Some examples of these include: the market underestimating the durability of growth, outsourcing trends, differences in investor time horizons and value-added mergers and acquisitions (M&A).

We will highlight some of these other topics in future commentaries, but we wanted to discuss the M&A framework this quarter. Contrary to popular belief, some companies are good at conducting M&A. These companies are typically part of large, fragmented industries that comprise lots of smaller players, employing an acquisition approach designed to build out more robust product offerings. Oftentimes the larger company provides additional resources (operational prowess or financial backing) to the recently acquired company, helping to accelerate its growth rate.

Typically, these types of M&A transactions are strategically driven, standing in contrast to financial acquisitions that are usually more focused on cutting costs. Minimal product overlap is a key consideration for antitrust review and too much overlapping exposure could result in a transaction being blocked.

A careful look at M&A transactions is an area to explore, since we find that Wall Street is not incentivized to forecast M&A transactions and they underestimate the operational improvements that best-in-class operators can achieve.

Course of Action

For the fourth quarter, we did not make any major shifts in our portfolios. Rather, the tilt in our barbell approach back towards growth, and specifically in the Technology sector (as detailed in our 3Q commentary), proved helpful. Overall, 2021 performance in portfolios was driven by two key themes: recovery or re-opening from the pandemic, and growth or benefits from secular tailwinds, primarily focused on Consumer, Healthcare and Technology companies. While common macro headwinds such as the delta and omicron variants, commodity inflation, and lockdowns proved to be mostly noise for the markets, our active management allowed portfolios to participate in a strong up year.

During the quarter, we did trim some winners as key catalysts were realized during earnings season, and we were able to realize some of the gains in what was already a strong market. This resulted in some higher cash balances in some portfolios.

It seems that yet another market rotation has begun as we start the New Year. The Federal Reserve's acknowledgement that inflation is no longer viewed as transitory, and the market's subsequent reaction to unexpected additional rate hikes in 2022, will benefit companies that would gain from a higher rate environment. Given our outlook, we expect a number of rotations to occur throughout the year. For now, we continue to have significant exposure in the Consumer Discretionary, Healthcare and Technology sectors and less exposure in the Consumer Staples, Real Estate and Utilities sectors. However, through fundamental research, our team will evaluate whether or not the barbell needs to be tilted in a different direction yet again, while taking into account the variety of trends heretofore identified, in identifying investment opportunities.

Important Disclosure Information

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