Fourth-Quarter 2021
American Portfolios Quarterly Market Commentary

by Chief Investment Officer Clifford T. Walsh, CFA

THE FOURTH QUARTER financial market returns were surprising—but certainly not unwelcome—and capped off a strong year. The S&P led all major equity categories for the quarter yet again with a gain of 11% and finished the year up 28.7% (about 70% from the end of the first quarter of 2020). Large-cap stocks led the way for the year, nearly doubling the return of small caps (up 14.8%). International markets trailed for the quarter and the year with developed markets up 11% in 2021, while emerging market equities declined 2.5%. The U.S. aggregate bond index was flat for the quarter and down 1.3% for the year, dragged lower by weakness in long-dated Treasuries in the first quarter. REITs were a particularly strong performer in the fourth quarter (up 15%) and for the year (up 39.8%).

ECONOMIC OVERVIEW

The last seven quarters of economic activity have been driven by tsunami waves of activity. First, government spending and coronavirus pandemic-related stimulus actually fueled an increase in personal income, while GDP contracted 33% in the second quarter of 2020, which was followed by even more government stimulus. Second, the Federal Reserve (the Fed) added support by cutting interest rates to zero and more than doubled the size of its balance sheet to nearly $8.7 trillion. Finally, we had a wave of reopening activity that helped fuel the economy toward normalization, but certainly not without issues, as the recent inflation rates prove (still up 7% YOY for December).

These perfect storms of activity have already hit the shores, so to speak, and will no longer provide momentum for economic activity. We now need to assess how the economy and financial markets will perform as the storm surge recedes from the shores. As gridlock in D.C. has increased with the passing of each record bill, we also inch closer to the 2022 elections, which will likely further dampen the potential for increased spending. I'll address this more later in the commentary, but just know that government spending is likely to detract from GDP growth in 2022, despite our grandiose spending patterns.

Furthermore, not only is the Fed tapering its bond purchases into March (two quarters early from market expectations two quarters ago), but the market continues to increase its forecast for rate hikes, another impediment for growth; I'll also discuss more on this later. It is looking more and more likely that aggregate demand will slow just as the final tranche of supply hits the economy easing inflation, only to be met with an aggressive rate hike cycle.

The fiscal and monetary drag on the economy is significant and one that we doubt will lead to meeting current consensus GDP expectations of nearly 4%. In fact, we expect it to be less than half of that, and this is with the assumption that Omicron or another coronavirus strain doesn't force a significant pullback in spending. We ask the question, if the government does not replicate the massive amount of stimulus

from the past two years, will the economy make up for it? With so much demand pulled forward from increased savings rates and low interest rates, we doubt it. We also wouldn't be surprised to see a negative quarter of GDP in the back half of the year, particularly as the rate increases gain steam.

INFLATION

Our view on inflation has not changed (See our Third-Quarter 2021 Quarterly Market Commentary) for a more in-depth look). The bulk of higher prices have been led by pandemic-related industries that experienced supply shocks and shortages—and wacky comparisons of how a current reopened economy looks against one that was constrained with lockdowns and abnormal consumer behavior. Within three to six months, the bulk of these unusual comparisons will roll off and C.P.I. will return to more normalized rates. That is not to say the Fed should raise rates or reduce the size of its balance sheet—it needs to be done; the markets need to be weaned from a once-in-a-lifetime level of emergency support. We just fear this will be done more aggressively than necessary because supply-side inflation issues are being mistaken for demand-driven inflation.

THE FED AND EXPECTATIONS

The Fed is in a precarious position. Pushing interest rates to emergency levels while exponentially increasing the size of the balance sheet helped stabilize the economy during a very uncertain period; however, it has also fueled massive risk-seeking behavior and valuation multiple expansion within the equity markets. It now faces the difficult task of removing the excess liquidity and rightsizing rates without pushing the economy into a recession or driving equities into a bear market. We're pretty certain the Fed will get it wrong.

Unless equity markets pull back substantially in the next two months, shaking the Fed's confidence, rate hikes are coming. Will we get four hikes that are nearly factored into the futures markets for 2022 at this point? Probably not, but we will still get two and maybe more.

Before the release of the FOMC minutes last week, the odds of a rate hike for March 2022 were about 40% and now they are double that, while we're also staring down expectations for three to four hikes in 2022. We've seen this too many times before. The Fed eases too much and then overtightens. Just look to 2000, 2006 and 2018 as examples. The Fed believes it reacts to the business cycle, but it actually drives it. History shows that Fed tightening cycles lead to recessions 80% of the time. We now embark on another tightening cycle with a bubble in corporate credit, U.S. equities and housing.

We severely doubt the Fed ever gets to 1.75% in 2023 as the futures markets predict currently. It is much more likely the Fed either pauses because it sees aggregate demand slowing or even lowers rates because a recession ensues from too many hikes too quickly. The Fed is not known for its "in-game" adjustments, but it has reacted quicker in recent years than throughout history.

To summarize, easy money is done and the equity markets have been slow to react to it. 2022 is going to be a very interesting year.

GEOPOLITICS

After negotiations on the Build Back Better (BBB) Act, which was stalled late last year, the outlook for fiscal legislation is murky at best. The Senate is unlikely to pass a comprehensive bill similar to the House-passed BBB. A scaled-down reconciliation bill combining energy/climate and fewer benefits (universal pre-k and expanded health insurance subsidies) is still possible. However, at this point the probability looks less than likely.

We expect Congress to pass legislation boosting spending in other areas. The most likely is research funding and manufacturing incentives the Senate passed last year as part of its economic competitiveness legislation. A modest COVID-relief package also looks possible, though the amount of funding would likely be small. However, none of these measures—if they even pass—will come close to matching the massive stimulus of 2021, meaning all else equal, a drag on economic growth. On the positive side, this lack of spending, relatively speaking, means that tax increases are also less likely. While any reconciliation bill would likely include some corporate tax increases, the probability of those tax increases has faded along with the broader legislation.

Before mid-year, the policy debate is likely to be overwhelmed by the upcoming mid-term election. Democrats look likely to lose their majority in the House in light of historical trends, their current thin margin, and recent polling, approval and economic data. The Senate looks tighter, however. It will be interesting to see if more gridlock in the Capitol will lead to less spending.

We also expect more upheaval at the state and local levels. While we view the potential for social unrest as significantly less than in 2020, this possibility exists as well, although it’s not likely to impact the financial markets.

OUTSIDE THE U.S.A.

After a rough year in China and many surrounding emerging markets, is there hope for markets abroad? We think so, but with some concerns. Vaccination rates, the interest rate cycle and valuations give us reasons to be bullish, while the Evergrande/developer debt crisis is a risk, as is currency.

Vaccination rates in key emerging market countries, such as China, Taiwan, South Korea and most of Latin America, are well ahead of the U.S. This gives us comfort that these economies can handle new variants as well as the U.S., albeit with the risk of more aggressive shutdowns. Many emerging market Central Banks also have lower inflation rates than the U.S. and are further along in their rate hike cycles. Many Central Banks began raising interest rates well ahead of the U.S. and Europe in 2021 and are already in the second half of their rate hiking cycles, whereas the U.S. looks to begin in March or June.

The biggest risk we see here is the debt position in China. The Evergrande situation has not spread beyond Asia, as we expected, but China is clearly not out of the woods just yet as required debt payments total roughly $20 billion in the first quarter of 2022—double that of the fourth quarter 2021. As

financial strains lengthen and grow in size, the risk also grows. Looking forward to the second quarter of 2022 also doesn't offer much help with a required $18.5 billion due. If China can navigate this issue well during the first half of the year, there will be opportunities to be had, even if policymakers remain committed to long-term de-risking. The spread between U.S. and emerging market valuation multiples offer historic opportunities.

Our remaining concern is that the U.S. dollar mutes or negates emerging market returns as rate hikes begin. Interestingly, the U.S. dollar's performance has not correlated to the rise in futures market expectations for higher rates. The non-confirmation could be a signal that traders don't buy into seven rate hikes through 2023 or, the riskiest conclusion, the dollar is a notable risk to the emerging markets and will soon adjust. We will continue to watch this closely.

THE MARKETS

If you look at the headline market returns that closed out 2021, along with those projected into 2022, one certainly wouldn't be excited … but a deeper look might be a lot more surprising. Forty percent of Nasdaq stocks are down 50% or more from the nearby peaks; two-thirds of the index is down at least 20%. Not to mention the start so far in 2022 is the worst since 2008. The Russell 2000 is also in the midst of a correction. Within the S&P 500, more than 200 stocks are now down at least 10% from the recent highs and 33% are down 20% or more. These notable moves have been hidden by the mega-cap stocks and their oversized impact on index returns. We think this makes it much more likely that active managers will outperform in 2022 compared to the past few years and is a key investment theme for us.

Fed tightening is also a major theme for us this year. Don't fight the Fed, as they say. What it has given to the markets these past two years in easy money is about to cycle back the other way. The headwinds seem to get stiffer by the day. Aggressive Fed hikes could not only create significant pressure on GDP and corporate earnings, but it could also kickstart a reversion in real estate cap rates, equity earnings multiples and spreads in the high-yield bond market. Across the various asset and sub-asset classes, valuations sit anywhere between two and three standard deviations from normal. When the pendulum swings, it often doesn't stop dead on at fair value. We see financials and energy as particularly risky areas.

We have the makings of at least a brief pullback of 20% or more occurring at some point this year, if not something deeper and more prolonged. So, risk management is another key theme for 2022.

Diversification, non-correlated or even negatively-correlated fixed income, and alternatives—as well as a focus on behavioral investing and possible mistakes (e.g., fear, greed, overconfidence extrapolation/anchoring)—are just some of the traits that will be in heightened focus this year.

As far as diversification goes, long-duration bonds look attractive as rate hikes slow economic growth, inflation eases and demand potentially increases from risk-off seeking behavior. Those who have benefited from the value stock/reopening trade may look to growth as it becomes scarcer and long-duration bonds rally. Emerging markets also provide the potential for opportunity. The performance

spread between emerging market and U.S. equities is at multi-decade highs. Global institutional investors are also over 800 bps underweight EM equities. We also see higher GDP and earnings growth rates and valuations that are actually below historical average, a unicorn in the U.S. markets.

Overall, we continue to believe that one's investment focus should become increasingly thematic and more selective than in the past because the equity markets, and financial assets in general, have become extended. Broader asset prices don't reflect the mid- to long-term economic outlook because the financial markets have been boosted by unprecedented fiscal and monetary policy stimulus, requiring nimbler and more focused asset allocation down to the industry and stock levels. While valuation is not a reliable timing tool, current levels suggest limited long-term gain potential based on history—and now, government and Fed tailwinds have shifted to headwinds creating a situation ripe for reversion to the mean.

Mid-term elections have historically been volatile, and the upcoming one may prove to be a silver lining for a difficult year. Perhaps gridlock will equal less spending, less debt and fewer tax hikes, which could fuel a year-end rally—from what levels, though, remains to be seen. It is important to note, as we learned following 2016, one must not allow political beliefs to cloud market views.

In conclusion, we advise a fresh look at diversification, a greater focus on uncovering new opportunities, and risk management in the months and quarters ahead.

QUESTIONS AND COMMENTS

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