Independence Asset Advisors

MarketMatters

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Market Reflections
Don't Count On It
By Scott Renninger

It's time again for "Wall Street" to look into their crystal balls. In the midst of uncertainty, analysts keep churning out impossible predictions. This may be an especially good time to be aware of how little these predictions mean in a complex global economy and uncertain world. What do I mean?

Jeff Sommer of the Wall Street Journal reported Wall Street's consensus forecasts from 2000 to 2020 missed their targets by an average of 12.9 percentage points. That's more than a 100% average error ratio! Wall Street analysts are ever optimists, but the 2021 consensus forecasts missed on the low side. Bank of America was predicting the S&P 500 would close 2021 at 3,800 as recently as September, but when the index blew through that estimate, it raised its "forecast" belatedly while its model kept spitting out negative U.S. stock returns. The last time that happened was 1999, shortly before the dot-com bust. A warning to investors?

The median 2021 forecasted closing level for the S&P 500 (SPX) was 3,800 according to Bloomberg's survey. The index was trading between 3,500 and 3,600 at the time these forecasts were developed, which called for single-digit market returns. (Admittedly, my personal call for an 8% increase to 4,055 was not much better.) So where did the S&P 500 end 2021? 4,766 for a total return of 28.7%!

Where will the S&P 500 close at the end of 2022? The current Wall Street consensus is 4,825 (Bloomberg), which represents a minor pick-up over its current level. Don't count on it.

At least two major firms are predicting significantly negative returns for U.S. stocks, including Morgan Stanley at negative 5% to 4,500.

Take a moment to write down your prediction for the 2022 closing level of the S&P 500. It may be humbling to see how wrong we can be.

I'm thinking the SPX at an even 5,000 would be a nice way to end 2022 … a modest 6.3% total return on stocks for the year. But don't count on it.

2021 KEY TAKEAWAYS

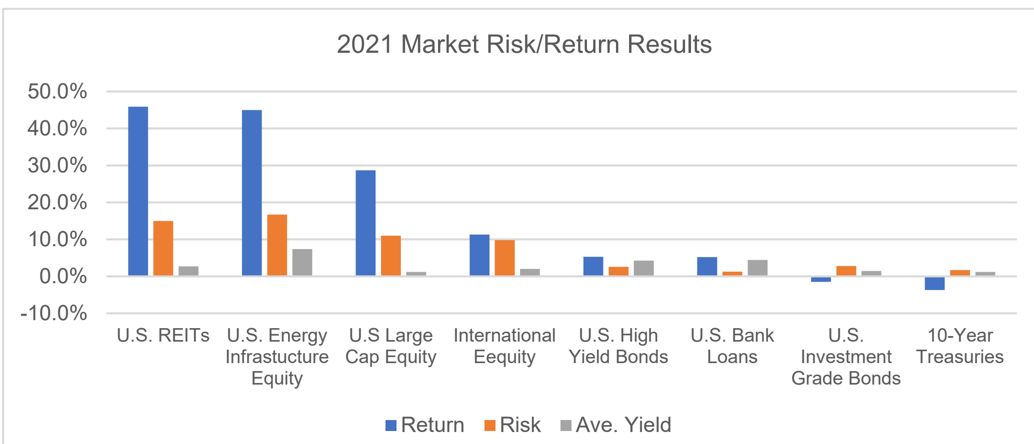
- The COVID market characterized the year and drove market volatility.
- Time and time again, investors brushed off news that would have derailed markets in prior years, including higher inflation, which rose at its fastest clip since the 1980s.
- The S&P 500 Index notched **70 all-time record highs** in 2021, second only to 1995, but these records were driven by only a handful of stocks.
- Energy infrastructure equity and U.S. REITs were the best performing sectors, but represented only a fraction of the total U.S. equity market.
- Bond investors had a particularly tough year, with U.S. investment grade bonds falling 1.5%, and long-term Treasury bonds losing 4.7%.

Market Recap

Over the past year, headline risks included a riot in our nation's capital, multiple COVID variants, tangled supply chains and a spike in inflation. It was also a hard year for anyone trying to beat the headline S&P 500 Index. An investor would have had to either been extremely lucky or willing to take inordinate risks - or both.

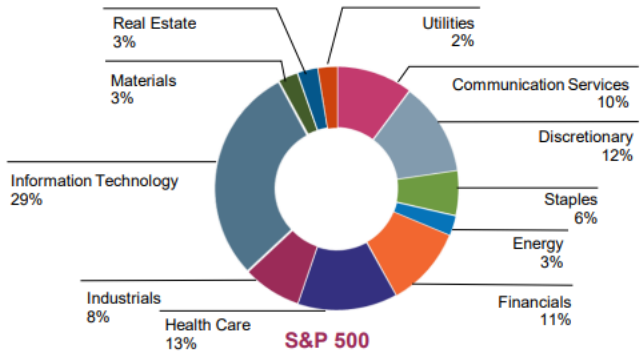
On the surface, 2021 was a smashing year for investors. The S&P 500 Index (SPX) gained 28.7% with barely a drawdown to break the momentum. The Index spent all but one day within 5% of its multiple all-time highs. This capped off three consecutive years of stellar gains where the S&P 500 Index returned an average of 26%!

But dig a little deeper and 2021 was a challenging year for many investors - particularly those committed to diversification and risk control. Bond investors had a particularly tough year, with U.S. investment grade bonds falling 1.5% and long-term Treasury bonds losing 4.7%. Fixed income investors astute enough to navigate increasing duration risk were not rewarded, as high-quality shorter-term bonds paid very little, but fared well in high yield bonds and loans that returned over 5% for the year.



Despite persistent headline risk, investors remained optimistic throughout the year and poured record amounts of capital into large-cap growth and equities indexes. U.S. REITs and energy infrastructure equities were the year's best performing sectors, with the categories each posting gains in excess of 45%. However, these sectors drove only a fraction of the U.S. equity market's gain in 2021, as they made up just 6% of the total U.S. stock market capitalization. Being overweight real estate and energy stocks would have improved return.

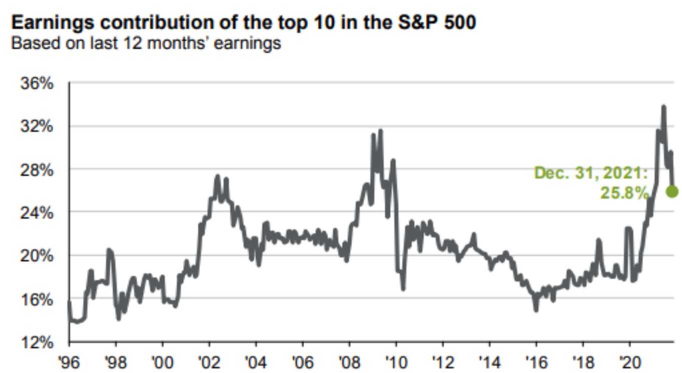
2021: S&P 500 Sector Weights



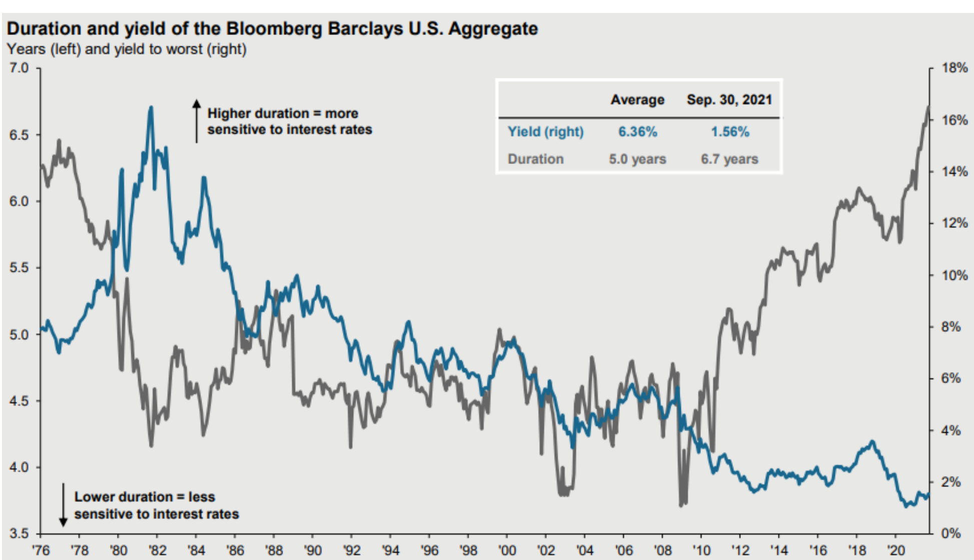
Taking a closer look at the U.S. equity market, last year's gain was bifurcated, with fewer stocks participating in the market's gain during the back half of the year. While the early months saw upwards of 90% of constituents in the S&P 500 Index trading above their 200-day moving average, less than 60% did so as the year progressed. In fact, only five stocks, Microsoft, Google, Apple, Nvidia and Tesla, accounted for 51% of the S&P 500 Index return between April and December. The point? While a single sector led the way, an investor would have needed exquisite timing to benefit.

By the end of 2021, U.S. stock market concentration remained prevalent. The five aforementioned market-driving stocks combined with large-cap growth stocks to represent the highest concentration in stock market history, with a combined capitalization weighting of 31% of the index.

This unprecedented concentration creates a significant risk in 2022 as the same ten stocks traded at 168% of their average P/E at year-end, while their collective earnings contributions to the Index moved consistently lower.



With regard to fixed income markets, 2021 was a challenging year for investors that maintained an allocation to higher quality bonds. With yields inching higher from near historical lows, and prices falling as a result, total returns were mostly negative for taxable and municipal investment grade bond indexes. For investors willing to take on additional credit risk, high yield bonds and floating rate loans offered gains of about 5%.



With credit risk less of a concern, the prevailing headwind for conservative bond investors was duration risk. At year-end, the spread between the yield and duration for the Bloomberg U.S. Aggregate Bond Index was at an all time high. This suggested investors were not being adequately rewarded for the risk of interest rates moving unexpectedly higher. For context, assuming a parallel shift in the yield curve, and a 1% rise in interest rates, U.S. investment grade bonds would have declined by as much as 5.0% (total return), while 10-year U.S. Treasuries would have fallen 7.3%.

Sources: JP Morgan, Eaton Vance, Fiera, Forbes

KEY INSIGHTS:

- The Fed exercises two main tools to implement monetary policy: The Fed Funds rate and Quantitative Easing.
- During the 2020 economic crisis, 0% interest rates and the Fed's bond buying program made the economy flush with cash.
- After a sustained period of inflation, the Fed is now tapering its bond buying and projecting future interest rate increases.
- Tapering will reduce liquidity in the economy, but may ease inflationary pressures.
- The markets will continue to react to Fed guidance, and Fed decisions may cause markets to vacillate between climbs and declines throughout 2022, increasing bond and stock market volatility.

BACKGROUND:

The United States central banking system, known as the Federal Reserve, is comprised of the Federal Reserve Board of Governors (Board of Governors), the Federal Reserve Banks (Reserve Banks), and the Federal Open Market Committee (FOMC). Jerome Powell, oft quoted by media outlets, is currently the Chairman of the Board of Governors. The Fed performs numerous functions to promote the effective operation of the U.S. economy and, more generally, the public interest. We'll focus on one of these due to its prominence and dynamic nature:

> ***Conducting the nation's monetary policy to promote maximum employment, stable prices, and moderate long-term interest rates in the U.S. economy.***

The FOMC makes all decisions regarding the appropriate "stance" of monetary policy for the country in order to help move the economy toward the goals of **maximum employment** and **price stability** (~ 2% long-term average inflation). The FOMC raises and lowers its target range for the *federal funds rate* (the rate at which banks lend to each other) to achieve these objectives. The Committee can also implement **balance sheet policy**, whereby it changes the size and composition of the Federal Reserve's asset holdings by buying or selling securities on the open market to assist with market functioning and help foster accommodative financial conditions.

MONETARY POLICY:

Monetary policy most directly affects the path of short-term interest rates; short-term interest rates (actual or anticipated) in turn affect overall financial conditions, including longer-term interest rates, stock prices, and the exchange value of the dollar. Monetary policy therefore affects the choices of consumers and businesses, including their overall spending, investment, production, employment, and inflation.

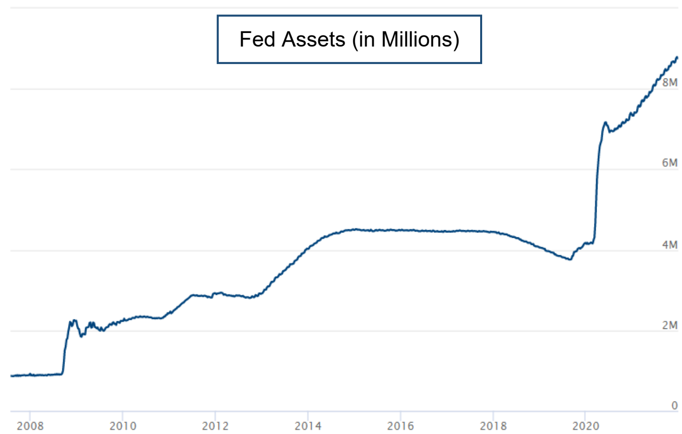
When the economy slows, the Fed lowers interest rates and buys bonds on the open market to encourage spending and avoid a precipitous economy decline. Lower interest rates make financing more affordable, which stimulates both capital investment and consumption. The increase in these activities helps to stabilize economic activity and employment. With increased demand, prices will also stabilize, avoiding the potential downward spiral of deflation. The Open Market Desk at the Federal Reserve Bank of New York buys or sells U.S government-backed and agency-backed securities, increasing or reducing the assets that the Fed owns, or its balance sheet. Buying long-term securities on the open market (also known as **quantitative easing**) helps put downward pressure on long-term interest rates. Because the remaining quantity of securities available for public purchase declines, bond prices rise. Yield, the return on a bond, consists of the coupon/interest payment of the bond divided by its price. So, when prices rise, yields fall accordingly. When the Fed purchases securities, banks that owned them also have increased liquidity. This increase in liquidity infuses the economy with cash, which can cause inflation if increased lending leads to excess cash chasing too few available goods.

2020-2021: COVID RESPONSE

During the COVID crisis and ensuing global recession, the Fed responded quickly by cutting interest rates to zero in March 2020 and increased its balance sheet dramatically. From June 2020 through October 2021, the Fed bought $80 billion of Treasury securities and $40 billion of agency mortgage-backed securities *each month*. The Fed's balance sheet reached a peak of about $4.5 trillion after the 2008 recession before it began to decrease, and it now stands at over 8 trillion after COVID-related quantitative easing. After the crisis receded and economy stabilized at the end of 2020, inflation began to pick up steam.

The Consumer Price Index increased 6.8% in the 12 months ending 11/30/2021. Food, energy, transportation and shelter costs all increased sharply. With numerous comorbid causes of this spike, including increased demand, supply chain disruptions, and worker shortages, the Fed at first hesitated to make changes to its policy. When inflation showed no signs of slowing at the end of 2021, the Fed began to "taper" its bond buying program.

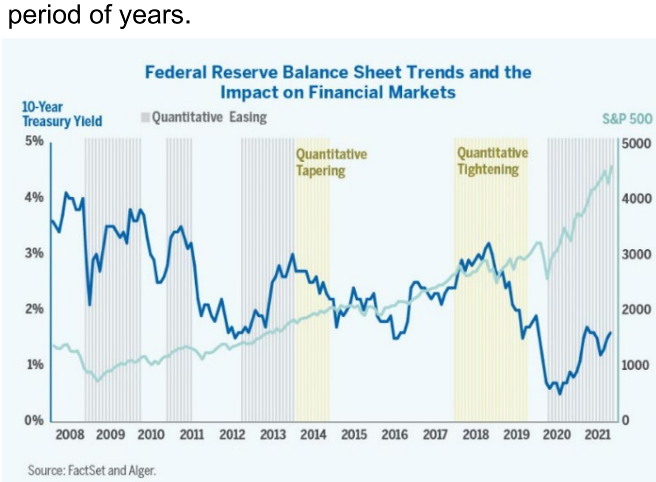
CURRENT EVENTS: TAPERING



"Tapering" means that the Fed will reduce its future bond purchases, but it doesn't mean that the size of its balance sheet will shrink immediately. Rather than hitting the brakes, the Fed is easing up on the gas pedal. In November 2021, the FOMC indicated that the economy has made enough progress (good employment numbers, GDP growth, etc.) that tapering would begin in order to promote the goal of stable prices. Starting in December 2021, monthly asset purchases were reduced by $20 billion for Treasury securities and $10 billion for agency securities. In January 2022, the FOMC consensus was that tapering should accelerate to a total of $50 billion less in security purchases per month. Tapering will ease the downward pressure on interest rates, possibly causing a fall in bond prices and increasing yields. It most likely won't cause prices to decline, but it may help to moderate inflationary pressures by slowing the flow of cash going into the U.S. economy. Further, the Fed's actions won't help to ameliorate other causes of inflation, like supply chain snares and labor shortages. Tapering precedes (and paves the way for) interest rate increases, but the economy must continue to pass more stringent tests in the near-term before the Fed puts 0% interest rates in the rear-view mirror.

Tapering is one step towards a tighter monetary policy. Along with the eventual phase-out of the Fed's bond buying program, it has the potential to lift bond yields and affect the global flow of capital. But just as important is what the action indicates for the future- it's the first step in a series of monetary policy changes that includes higher interest rates (quantitative tightening). Current projections show a likely three 0.25% rate increases by the end of 2022, followed by three more increases in 2023. Altogether, benchmark rates could rise by 1.5% by the end of next year.

Higher interest rates can dampen borrowing, lessen consumer spending and hurt corporate profit margins. This has the potential to hurt market returns. However, monetary policy being less accommodative going forward is not inherently cause for general economic alarm bells to ring. The fed funds rate was over 2% at the beginning of 2020 (before the advent of COVID lockdowns) and had been rising for four years. The economy was still thriving, with a strong housing market, full employment, and low-to-moderate inflation. Rising rates should be a consequence of a strong economy, as the Fed will be hesitant to raise rates if the economy is struggling. The Fed aims to raise interest rates *in response to* robust economic indicators. Inflation values may throw the Fed a curve ball, but the fed funds rate will likely remain low by historical standards for an extended period of years.



In the two prior tapering cycles, the S&P 500 continued to climb due to the strong economy and increasing corporate earnings. The graphic (left) shows the performance of the S&P 500 and 10-Year Treasury Yield in past tapering cycles since the 2008 recession. Although there is little room for 10-Year treasury yields to fall this cycle, it would take a significant increase in interest rates to be considered significant Fed tightening.

Markets have begun to price in rate increases, but that pricing will continue to adjust to changing circumstances. Fed guidance moves markets, oftentimes abruptly, so the Fed's opinions and decisions on the timing and extent of its measures will have broad market implications. Non-Fed factors like earnings forecasts or headline risks can have outsize affects in the context of narrowing monetary circumstances, cause market shifts, short-term dislocations and, possibly, market corrections. No one can predict the nature, timing and severity of these with confidence (when it comes to predictions, **Don't Count on It**!). In these times, just as ever, the best course of action is for long-term investors to keep these fluctuations in perspective and "**Stay the Course**".

Sources: Federalreserve.gov, Brookings.edu, BLS.gov, FactSet, Alger

We want to take this opportunity to share our outlook for markets, derived in large part from our view of U.S. and global economies and current valuations. These thoughts reflect our reading of over a dozen sources. While many sources had similar themes, some diverged, but in the end, what you see below is our base-case for 2022.

As markets fully digest the likely economic impact of Omicron, investors have quickly reverted their attention back to growth, inflation, and interest rates. As we look to the next 12 to 18 months, growth will wane, but remain above long-term real 2% GDP trend. Hopefully inflation will wane with growth but will most likely remain at a level higher than the Fed's 2% target. With all eyes on the Fed, it will not be all about rate hikes. Where the 10-year Treasury ends up a year from now may well be the greatest determinant of stock and bond market performance.

The three broad keys to investing in 2022 are (1) the pace of growth, (2) the pace of inflation and inflation expectations a year hence, and (3) the impact on short-term interest rates and the yield on the 10-year Treasury note. Other trends that will help determine market outcomes are noted below. There is clearly a lot to consider this year.

1. Global growth above long-term trend with the economy moving into mid-cycle.

2. The savings rate spiked during peak pandemic times to over 30%, but now it is already back within historic ranges and continues to decline. At some point, consumers will need to slow spending or dip further into savings. More workers will return to the work force, helping to relieve some pressure exerted by labor shortages.

3. 2022 should be a year of inventory rebuilding as supply chain problems are resolved. All logistics problems won't be solved this year, but a lot will. Much depends on how the COVID pandemic evolves.

4. Housing and auto industries, in particular, should grow at a rapid pace given the lack of inventory at the end of 2021.

5. Congress could pass a watered-down, more targeted Build Back Better bill and could increase taxes on businesses and the wealthy, but the odds fade as time passes. It's hard to believe that Democrats want to increase taxes in front of spring primaries.

6. Demographics are destiny. 2021 population growth was 0.1%, the smallest in modern history. A combination of a very low birth rate plus COVID deaths combined to a net addition of just 249,000. Add in a lack of immigration for the past five years that has inhibited working age labor force growth by 400,000 workers per year when compared to the prior 20 year average. Even assuming fewer Covid-related deaths in coming years, it appears lower population growth will be a significant negative influence on long term growth as more baby boomers retire – at least until Congress gets its act together on reforming legal immigration.

7. China faces even worse demographic issues. Its growth, which was about 6% pre-Covid, could be cut in half within a few years. Europe's and Japan's demographics are even more dire. Global growth is slowing, which is deflationary over the intermediate to long-term.

8. Further Earnings Per Share (EPS) upside will support stocks, while (in the best case) multiples may continue to slip slowly. Below the total market water line, expect a more significant contraction in low-earning growth stocks with extremely high multiples. An example might be Tesla whose stock currently sells for over $10 million per car sold. (I love the cars but…)

9. High-multiple growth stocks will continue to see multiple contractions in response to a rising 10-Year Treasury yield – leading us to prefer high quality earnings growers that compound returns as the economy grows.

10. High prevailing inflation should ease by mid-2022 but remains a significant risk in both directions.

11. All eyes on the Fed… the Federal Reserve has started to taper asset purchases and will stop adding to its balance sheet by the end of March. After that, the question is when it will begin to raise interest rates. Right now, markets are pricing in three 0.25% increases totaling 0.75% by year-end, but what actually happens will be determined by both growth and inflation. With monetary and fiscal stimulus already diminishing, both growth and inflation are expected to slow, especially in the second half of 2022.

12. Money supply will recede as the Fed slows its pace of bond purchases and Covid-related government spending decreases – tightening financial conditions even before the Fed's first rate increase. There may be downside "risk" to market expectation of Fed rate hikes if growth and inflation slows below 3% in the second half.

13. Beyond bond yields moving up slowly, demand for bonds will increase incrementally as rates rise. The global demand for income will keep pressure on a flattened yield curve.

Add all this together, and you get a picture of slowly decelerating growth in 2022. While growth should remain well above 2% trend going into 2023 because of inventory rebuilding and strong capital expenditures, strength in autos and housing, and fading but positive impact from cumulative monetary stimulus, maintaining growth much in excess of long-term trends in 2023 and beyond will be difficult.

Rebecca wrote extensively on the Fed and Tapering, so we will not repeat her educational essay, but we want to incorporate lessons from prior Fed actions into our outlook.

Take inflation: We all know the pressures that have lifted inflation the past year. Surging post-quarantine demand sent commodity prices soaring. Supply chain snarls led to shortages and higher prices. A tight labor market has and will continue to push wages up. Housing shortages lifted rents. Some of these pressures will be alleviated over the next year as supply chain issues get resolved. But it could take many months, or even years, before some higher value capital goods and big ticket consumer shortages are resolved. Higher than the 2% trend inflation is going to be with us for a while. The question is how much and for how long. Central bankers have underestimated inflation for a year but seem to refocus in the past few months. The transition from increasing accommodation to tightening will surely test the mettle of both bond and equity investors.

As for interest rates, inflation is a factor, but any asset price is a function of supply and demand. While the Fed will stop buying bonds over the next few months, deficits at both the Federal and state levels should also decline sharply. Interest rate spreads between the U.S. and overseas markets are another important factor. Rates across Europe and Japan remain largely negative. For overseas investors, the U.S. bond market looks relatively attractive and remains a strong source of demand.

Perhaps the biggest question, a hypothetical one now, is if the Fed is forced to choose whether to stimulate to bolster growth, or tighten to combat inflation, which would it choose? Right now, toning down inflationary pressures seems more relevant against a backdrop of GDP growth that approached 5% in 2021 before the impact of the Omicron outbreak. But as growth inevitably slows next year, the question could become relevant, particularly if inflation remains stubbornly high. Everyone seems to assume that most supply chain issues will be resolved next year, but didn't the Fed call inflation "transitory" until December? Like predicting long range weather, trying to isolate inflationary pressures 12 months hence is too difficult even for the Fed to determine accurately. The inflationary outcome and future expectations will probably be the single biggest factor determining the outlook of interest rates, bond yields and equity markets in the year ahead.

2022 looks to be a transitional year. In some sense that could be positive. As the world gets vaccinated and learns to live with Covid-19, and as government policies and business continue to adapt, the pandemic should be less disruptive a year from now. One couldn't have said that a year ago. While we are in the midst of the Omicron surge, economically 2022 should be another year of forward momentum in most regions of the world. Shortages will continue in the U.S. as supply catches up to the demand surge and inventory rebuilding helps alleviate stressed supply chains. As we move from peak growth to a more sustainable growth rate and lower inflation, business profitability is expected to normalize at a higher level due to technology adoption and improved productivity. That would be good news for both credit and equity investors.

On the other hand, U.S and global monetary stimulus will be reduced sharply, and federal Covid-related support will disappear. Money supply growth, an engine for economic expansion, will slow. Hopefully, so will inflation. At the moment the calculus of these plusses and minuses is hard to decipher. It should come into clearer focus as 2022 progresses.

Markets, as we all know, hate uncertainty. Thus, we expect volatility to increase somewhat from a very low level in 2021. After three years averaging over 20% equity returns, it is hard to see how 2022 will be a fourth. Earnings growth is decelerating, although EPS growth estimates are still a robust 10% to 15% for 2022, and will continue to decelerate into 2023. Interest rates should remain low by historical standards with negative real yields persisting for another year. The rolling corrections underway in overvalued growth stocks are purging some of the excesses out of the speculative end of the equity market.

A fairly good barometer for the year ahead will be market performance in January. At least, that is common wisdom supported by historic market cycles. So far, it has been a tough first week with a spike in bond yields and losses across U.S. and global bond and equity markets.

Connecting investment dots to the environment, we always prefer investments with asymmetric risk profiles where we can find them – less downside risk per upside potential. So, we advocate moving up-quality within the preferred markets and sectors shown below. We want to take risks that we are compensated for:

- Overweight U.S equities over International;
- Developed stocks over Emerging;
- High quality companies with sustainable earnings in cyclical sectors;
- Avoid overvalued large-cap growth stocks (i.e., Tesla);
- Overweight credit risk over rate risk (corporate over government bonds);
- Overweight high yield and loans over investment grade bonds.

We know bear markets, with declines over 30%, have only occurred during recessionary periods, and we do not see any sign of recession. We know time smooths out all but the worst market corrections, with positive equity returns in 32 of the last 42 calendar years despite average 14% intra-year drawdowns in the S&P 500. With volatility expected to increase this year, the ride may be bumpier, but we expect 2022 to offer positive returns to investors that stay the course.

Sources: Allspring Global, BlackRock, Blackstone, Eaton Vance/Parametric, HSBC, IFM Investors
J.P. Morgan, Morgan Stanley, Macquarie Investments, Schroders, U.S. Bank, Wells Fargo

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Global Market Investment Returns December 31, 2021

		Dec 2021	YTD	1-Year	3-Years	5-Years	10-Years
U.S. Large Cap Equities	S&P 500	4.48%	28.71%	28.71%	26.07%	18.47%	16.55%
U.S. Small Cap Equities	Russell 2000	2.23%	14.82%	14.82%	20.02%	12.02%	13.23%
Energy Infrastructure Equities	Alerian U.S. Midstream Energy	0.75%	45.01%	45.01%	7.94%	1.05%	--
U.S. Real Estate Equities	Dow Jones U.S. Select REIT	9.01%	45.91%	45.91%	16.84%	9.65%	10.70%
Global Equities	MSCI All Country World Index	4.00%	18.54%	18.54%	20.38%	14.40%	11.85%
International Developed Equities	MSCI EAFE	5.12%	11.26%	11.26%	13.54%	9.55%	8.03%
Emerging Market Equities	MSCI Emerging Markets	1.88%	-2.54%	-2.54%	10.94%	9.87%	5.49%
U.S. Taxable Fixed Income	Bloomberg U.S. Aggregate	-0.26%	-1.54%	-1.54%	4.79%	3.57%	2.90%
U.S. Tax-Exempt Fixed Income	Bloomberg Municipal Aggregate	0.16%	1.52%	1.52%	4.73%	4.17%	3.72%
High Yield Fixed Income	Bloomberg U.S. Corporate High Yield	1.87%	5.28%	5.28%	8.83%	6.30%	6.83%
Floating Rate Loans	S&P/LSTA Leveraged Loan	0.64%	5.20%	5.20%	5.63%	4.27%	4.69%
International Fixed Income	Bloomberg Global Aggregate Ex-U.S.	-0.07%	-7.05%	-7.05%	2.46%	3.07%	0.82%

- Global equities capped off a fantastic year with a strong 4.0% return in December to end the year up over 18.5%.
    - The highly contagious Omicron variant did little to disrupt markets as the world learns to manage through the pandemic.
- In the U.S., equity markets rose nearly 4.5%, despite third quarter real GDP coming in lower than the 2.6% consensus estimate.
    - The deceleration was attributable to weaker consumer spending, a wider trade deficit and a slower pace of home building.
- At the December meeting, the FOMC officially announced its intention to conclude tapering by March 2022, and the Fed's dot plot implied three rate hikes in both 2022 and 2023; Chairman Powell cited high inflation and falling employment rates as the catalysts for tightening.
- U.S. small and mid-cap equity index returns were positive, but muted, amid uncertainty about how Omicron could impact small businesses.
- Outside the U.S., foreign equities gained a combined 4.1% in December, with the price-to-earning discount to U.S. equities a wide 6.9x.
- In bond markets, nominal and real U.S. 10-year Treasury yields ended the year at 1.5% and negative 3.5%, respectively; inflation was 5.0%.
- U.S. investment grade bonds slid 0.3% lower as yields moved incrementally higher, with a Bloomberg U.S. Aggregate Bond yield of 1.8%.
- High yield bonds and floating rate loans gained in December and ended the year returning over 5% to lead all fixed income categories.
- International bonds declined 7.1% for the year, with the U.S. dollar strengthening 7.2%.

Source: eVestment Analytics, JP Morgan

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