

EQUITY MARKET UPDATE

As of 12/31/21 | Volume 10, Issue 12 | FFTAM.com

Stocks finished the year with a strong rally, and many indexes closed near record high levels. December gains came despite another surge in COVID-19 cases. The Fed also announced an accelerated taper and possibly three rate hikes in 2022 to combat inflation. Shortages in labor, parts, and energy persist. Investors are hopeful about the economy entering the new year as no mass lockdowns were announced despite record daily new infections from the Omicron variant. They believe that a fully open economy will lead to a moderation in both inflation and supply chain disruption. Even though the Fed is taking steps to remove some of the stimulus from the pandemic, conditions remain very accommodative for a growing economy.

Santa Claus Rally Pushes S&P 500 and Dow to Record Highs

The S&P 500 increased 4.47% in December. Returns were aided by a large jump in Apple, which singlehandedly accounted for over 30% of the gain. Despite that move, the rally was broad based. Only one sector (consumer discretionary) was negative for the month. The best performance was seen in the defensive sectors of staples, real estate, and utilities. Year-to-date, the S&P 500 was up 28.68%. The index made 70 record highs, the second most in history. It also marked the third consecutive year of double-digit gains. The S&P 500 experienced its best three year stretch for performance since 1997-1999. Microsoft, Alphabet, Tesla, NVIDIA, and Apple accounted for over 35% of the gain, while the result is over 40% when you include energy and financials.

The Dow Jones Industrial Average jumped 5.53% last month. Large gains in United Health, Amgen, Visa, and Apple explained 64% of the return and aided performance versus the S&P 500. Year-to-date, the Dow was up 20.95%. A lower allocation to technology, along with negative performance from Boeing, Verizon, and Disney hurt results.

The NASDAQ was barely positive in December, increasing 0.75%. The result is misleading. As stated above, monthly returns were skewed by the large increase in Apple. By removing that one company, the index would have dropped by almost 3%. Of the major indexes, the NASDAQ saw the largest range on monthly total returns among its constituents. For the third straight month, investors shied away from high valuation stocks as they contemplate tighter financial conditions in 2022. The NASDAQ trailed the S&P 500 in 2021 with a total return of 22.21%.

Large monthly gains were also seen in mid-to-small sized companies. The S&P 400 Mid-Cap Index gained 5.07%, while the S&P 600 Small-Cap Index increased 4.51%. In 2021, mid and small-sized companies rallied 24.73% and 26.74%, respectively. It was

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a strange year for these indexes. The small-cap index benefited from meme stocks, like AMC Entertainment and GameStop, as retail investors chased ideas being spread on the social media platform Reddit, while both indexes served as a barometer for investor sentiment about future economic activity.

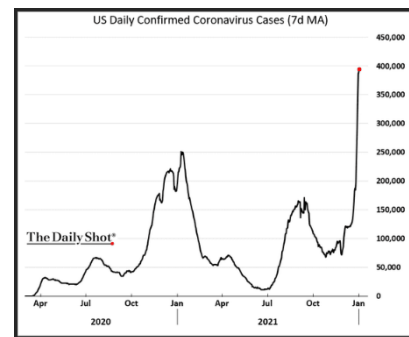
International Stocks Rise on ECB Bond Buying, Emerging Market Stocks Underperform on Weak Chinese Data

The Eurozone reopening hit a snag last month due to inflation and COVID-19. First, consumer prices were 4.9% higher than one-year ago. This was the fastest annual rise in inflation since records began in 1997, and it was more than double the ECB's 2% target. Shortages in parts, labor, and energy were the key drivers. However, core inflation, which strips out food and energy prices, was still 2.6%. The ECB insists the elevated prices are temporary and likely to fade in 2022. At their most recent meeting, the central bank vowed not to raise interest rates in 2022 despite running negative interest rates for over seven years. The ECB also announced an extension to its bond buying program while it winds down other stimulative measures. These actions were in sharp contrast to the Fed and the Bank of England, which became the first major central bank to raise interest rates by 0.25%. The IHS Markit European PMI Index was 53.4, a strong reading but the fifth straight month of deceleration. A decline in services (53.3 vs 59.9 in November) was the main culprit as several European nations tightened restrictions on nonessential activities to slow the spread of the Omicron variant. The MSCI EAFE Index increased 5.13% for the month, while year-to-date the index was up 11.86%.

The MSCI Emerging Markets Index gained 1.81% as Chinese economic activity slowed once again. COVID-19, supply chain disruptions, and concerns about property prices continued to weigh on activity. Retail sales grew by 3.9% year-over-year, but that was a full point lower than the prior month due to COVID-19 restrictions and weak demand for the annual "Singles Day" event. New home sales fell 0.3% during month, the worst reading in six years as the Chinese government tried to address unaffordable housing prices. The Communist Party released their 2022 economic plan in which their primary focus will be stabilizing the economy and keeping GDP growth within a "reasonable range." They listed employment, financing, trade, and investment as key areas for support. The report came less than a week after the People's Bank of China cut their reserve requirement ratio by 0.50% to boost the economy. Investor confidence took a hit after the US Commerce Department added more than two dozen Chinese biotechnology firms to their banned investment list. Finally, the emerging markets remain vastly below the developed world in vaccination rates, and they have been the source of most variants. Year-to-date, emerging markets are the only major index in the red with a loss of 2.47%.

Omicron Cases Skyrocket Worldwide, FDA Approves COVID Pills from Merck & Pfizer

Just one month after Omicron was identified in South Africa, the variant has become the dominate strain in new infections worldwide. As I discussed last month, Omicron spreads five times faster than Delta, which was 70% more contagious than the original strain of COVID-19. Fortunately, data from numerous regions indicate the illness produces more mild symptoms than previous versions, especially among vaccinated people. Breakthrough cases are more likely to occur with Omicron, but the risk is significantly reduced for people who have gotten the booster. New daily infections in many areas of the world, including the United States are at their highest rate since the start of the pandemic. To keep hospitalizations manageable for the healthcare system, the FDA approved the COVID-pills from Pfizer and Merck for emergency use among high-risk individuals. To alleviate the burden on businesses, schools, and day care facilities experiencing large employee absences due to infection, the CDC reduced the quarantine time to five days from ten days for fully vaccinated individuals that are asymptomatic.



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US Economy Improves, Inflation Hits Multi-Decade High, Fed Accelerates Taper

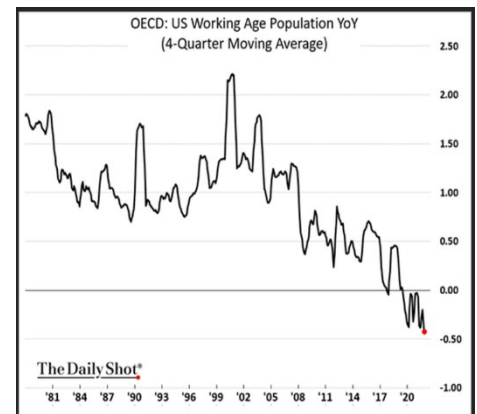
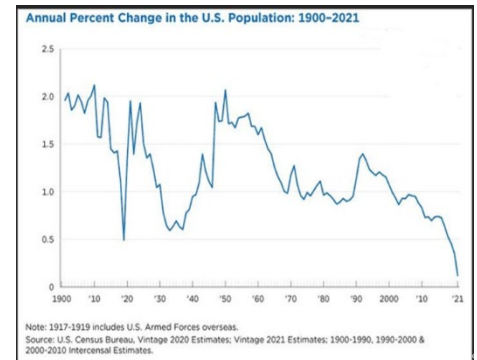
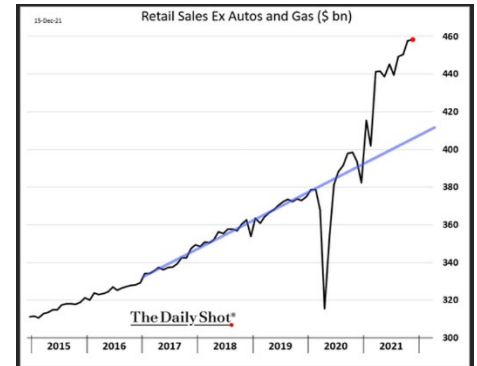
The US economy continued to show broad based signs of recovery. First, retail sales increased 0.2%, which was less than forecast. Much of that is due to earlier shopping for the holidays. Overall personal consumption data is running well above pre-COVID trends. The heavy level of shopping is making a lean inventory situation worse. Businesses are responding by increasing orders for nondefense capital goods. That is keeping the ISM Manufacturing PMI Index (61.1) firmly in expansionary territory. As consumers become less afraid of COVID, they are also boosting spending on services. This has lifted the ISM Services PMI index to an all-time high of 69.1. With continued supply chain disruptions, prices paid by producers are increasing. Last month, headline PPI was up 9.2% on a year-over-year basis! Some of that inflation is bleeding over to consumer prices as well. CPI rose by 6.8%, the fastest 12-month pace in 39 years and the sixth straight month in which inflation was over 5%.

To alleviate the situation, most firms are trying to hire additional employees, but they are experiencing difficulties. Jobless claims are at 52-year lows! Unemployment is 4.2%, and the participation rate continues to rise for prime age workers (25-54 years old). All these indicators point to an economy that is growing too fast in comparison to the size of its qualified workforce. There are more open positions on Indeed (11.2 million) than there are total unemployed people (7.4 million). As I explained last month, this is leading to higher wages, which in turn is causing the quit rate to explode, especially among leisure, hospitality, transportation, and warehousing jobs. The situation does not show any signs of improving. To make matters worse, the US Census Bureau announced population growth in the US is the lowest on record, while the size of the working age population is shrinking as Baby Boomers retire. The economic formula to address inflation and future growth is simple. We need to increase productivity among existing workers (we are seeing businesses increase their spending on technology). We also need to retrain the unemployed to possess the skills needed by the modern workforce, and we need Congress to pass immigration reform to increase the size of the labor pool.

The persistent inflationary data is putting more pressure on the Fed. At their most recent meeting, they announced a plan to double the pace of reducing bond purchases to \$30 billion each month. At that pace, the program would sunset by mid-March. The dot plots showed significantly higher expectations for rate hikes—3 interest rate increases in 2022 followed by another three bumps in 2023. Finally, the minutes of the Fed meeting also unveiled the possibility of shrinking the balance sheet due to their forecast of inflation remaining above the 2% target.

Elevated Valuation as Earnings Season Starts

We are on the cusp of earnings season. Investors will be paying close attention to fourth quarter results, but more importantly, they are interested in 2022 expectations from executives. Analysts believe earnings will grow by 21.3% in the fourth quarter on a year-over-year basis. If this comes to fruition, it will mark the fourth straight quarter of growth above 20%. Although that



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sounds fantastic, earnings growth continues to decelerate as yearly comparisons become tougher. Fast-forwarding to 2022, this trend is expected to continue as analysts have modeled earnings growth of 9.2%.

Currently, the S&P 500 trades at 22.87x 2021 EPS estimates. This is far better than the 26.28x trailing earnings reading, and it shows how rapidly corporate profitability has improved. However, even if earnings forecasts come to fruition, stock valuations remain pricey. If you fast forward to the 2022 and 2023 profit forecasts, the index trades at 21.13x and 19.27x, respectively. All these valuations are well above the 5-year average of 18.49x and the 10-year average of 16.61x.

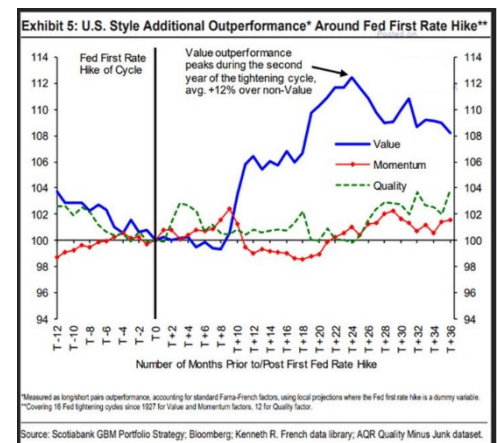
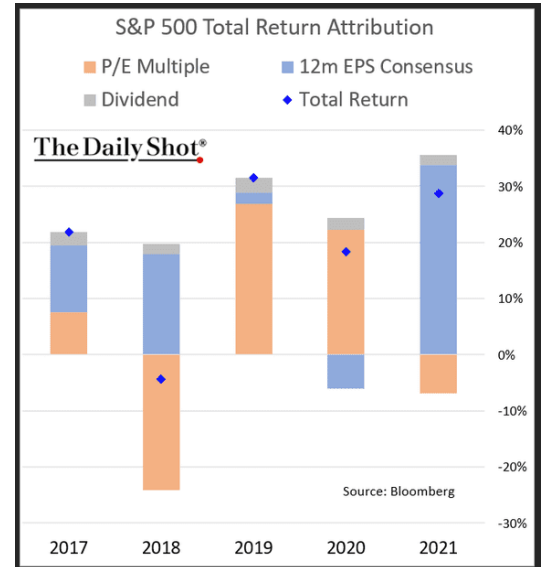
The valuations can be justified by low interest rates and the enormous amount of liquidity in the system. However, the Fed and other global central banks have announced reductions in their asset purchase plans as the global economy reopens and inflation readings remain elevated. This makes stocks ripe for increased volatility, especially among the higher valuation growth names. With stocks near all-times highs, the market is vulnerable to further consolidation or pullbacks in the next few months.

Our Outlook & Strategy

The stock market operated under three very different climates in 2021. For the first five months, investors' willingness to take risk was high, and they preferred the most economically sensitive stocks. That trend reversed itself during the summer months as the Delta variant spread across the globe and consumers spent their stimulus checks. This led to a rotation towards quality. As we approached year-end, worries about Omicron, inflation, and the Fed's removal of liquidity placed a premium on well capitalized, defensive companies.

Even though global central banks are starting the process of scaling back stimulus, they have vowed to go slow and proceed with caution, although the Fed's announcement of an accelerated taper indicates current conditions are too loose. This caused long-term interest rates to fall, and the yield curve flattened. The Fed's comments about possibly shrinking the balance sheet should allow long-term yields to grind higher as economic conditions normalize post-COVID. Bonds still trade at negative real yields (the rate on a bond minus the inflation rate) and credit spreads are historically tight. Therefore, the bond market is providing little competition to stocks, which is supporting the higher valuations.

With the Fed in play, earnings growth becomes critical as PE multiples historically contract during tightening. Stocks usually rise as the Fed hikes interest rates, although the pace of gains depends on the speed and size of the rate increases. An improving economy mixed with very accommodative monetary policy in the early stages of Fed tightening favors value stocks with a cyclical bias. We believe well capitalized companies in energy, financials, and parts of industrials are a great compliment to our overweight positions in healthcare and technology, both of which will benefit from long-term secular trends.



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