Fourth Quarter Market Review and Comment

January 2022

Updated Market Performance

Returns	4th Quarter 2021	Year to Date 2021	One Year	Annualized 3 Year	Annualized 5 Year	Annualized 10 Year
S&P 500	**11.03%**	**28.71%**	**28.71%**	**26.07%**	**18.47%**	**16.55%**
DJIA	**7.87%**	**20.95%**	**20.95%**	**18.49%**	**15.51%**	**14.21%**

Performance: October reversed September's losses posting a return of 7.01%. We were slightly negative in November returning -.69%. December rose 4.48%, marking the best December since 2010 (6.53%) ending the quarter with a total return of 11.03%.

After the 3rd quarter posted a gain of 0.58%, the 4th quarter closed the year out strong rising 11.03%. The Dow Jones Industrial Average (DJIA) underperformed the SP500, posting 7.87% gain over the same period. For the previous twelve months the SP500 has returned 28.71%, handily outpacing the DJIA which returned 20.95% over the same period. The annualized three-year returns are well above average (around 10%) with the SP500 three-year returns posting 26.07% and the DJIA three-year returns increasing 18.49%. Over the last five years the annualized returns are continuing to run well above historical norms (around 10%), with the SP500 returning 18.47% and the DJIA posting 15.51%. The ten-year annualized numbers are also running above long-term averages (around 10.00%), with the S&P500 returning 16.55% versus the DJIA which turned in 14.21%.

Breaking down the returns for the Q4 2021, we note that there were seven outperforming sectors and four underperformers. **The best sectors were Real Estate (17.54%), Information Technology (16.69%) and Materials (15.20%)**. **The underperformers during the quarter were Communication Services (-0.01%), Financials (-4.57%) and Energy (7.97%).** The best sectors over the last twelve months were Energy (54.64%), Real Estate (46.19%) and Financials (35.04%). Following behind, were Utilities (17.67%), Consumer Staples (18.63%) and Industrials (21.12%).

Economy: Growth in the economy will continue to be above average (Historical growth is ~3.00%). Expectations are that the first half will be stronger than the second half, benefiting from improving virus conditions, economic reopening, pent up consumption, and inventory rebuilding. Inflation should ease meaningfully in 2022, although price pressures are not likely to subside quickly. The Fed is tightening monetary policy sooner than anticipated to prevent runaway inflation. The Fed is expected to begin raising interest rates by the end of Q1 2022. Normally when the federal reserve begins to tighten monetary policy and raise short term rates, they usually end up thwarting growth and causing the economy to go into recession. We do not currently see recession risks on the horizon.

The third estimate of 3rd quarter 2021 Gross Domestic Product (GDP) is 2.3% according to the report released at the end of December by the Bureau of Economic Analysis (BEA). The latest estimate suggests that overall economic growth in the 3rd quarter decreased 4.4% from the 2nd quarter 2021 third estimate of 6.7%. GDP for 2020 came in at -3.5% compared to 2.2% in 2019, 2.9% in 2018 and 2.2% in 2017. Currently the Atlanta Fed GDPNow estimate (Forecast of U.S. GDP Growth) has forecasted 2021 Q4 GDP growth at 6.7%. By comparison, China says their GDP increased at 4.9% in the 3rd quarter of 2021. Decreasing from 2nd quarter 2021 increase of 7.9%. China's 2020 GDP was 2.3%, 6.1% in 2019, 6.6% in 2018 and 6.8% in 2017. Growth rates for the European Union (EU) and the Euro Area were 3.9% and 3.9% respectively in the 3rd quarter 2021. For 2020, GDP fell -6.1% for the EU and -6.37% for the Euro Area. For 2019, GDP rose 1.5% for the EU and 1.2% for the Euro Area. This is down from the 1.9% growth achieved by the EU and the 1.8% achieved by the Euro Area in 2018. GDP Growth forecasts for the end of the 4th QTR 2021 are 5.20% for the EU and 4.9% for the Euro Area.

Unemployment is continuing to trend down and continues to be below historical norms (~5.76%). According to the Bureau of Labor Statistics, December unemployment decreased to 3.9% from 4.2% in November. Unemployment for 2021 came in at 5.36%. Unemployment was 8.11% and 3.67% in 2020 and 2019 respectively. The number of unemployed fell by 483,000 in December to 6.3 million. Although both measures are much lower than their April 2020 highs, they remain above their pre-pandemic levels in February 2020 of 3.5% and 5.7 million, respectively. The labor force participation rate was unchanged in December at 61.9% but remains 1.5% lower than in February 2020.

Inflation increased 6.8% in November continuing its above average trend. After averaging 4.87% in the 2nd quarter 2021, inflation as measured by the Consumer Price Index (CPI) increased to an average of 5.37% for the 3rd quarter 2021. The average rate of inflation for 2020 was 1.23% and was subdued by historical standards (~2.49% over last 30 years). The energy index rose 33.3% over the last 12 months, and the food index increased 6.1%.

Consumption is an important driver of the economy as it represented 68.8% of 3rd quarter 2021 nominal GDP. The U.S. Census Bureau announced in December that retail sales for November 2021 were up 0.3% from October and were up 18.2% above November 2020. Gasoline stations were up 52.3% from November 2020, while the food services and drinking places were up 37.4%.

Manufacturing economy grew in December. Economic activity in the **manufacturing sector** expanded for the month of December, with the overall economy notched its 19th consecutive month of growth. The Purchasing Managers Index (PMI®) registered 58.7; a decrease of 2.4 from November's reading of 61.1. The Manufacturing PMI® continued to indicate strong sector expansion and U.S. economic growth in December. All five subindices that directly factor into the Manufacturing PMI® were in growth territory. All the six biggest manufacturing industries expanded, in the following order: Chemical Products; Fabricated Metal Products; Computer & Electronic Products; Food, Beverage & Tobacco Products; Transportation Equipment; and Petroleum & Coal Products. The New Orders and Production indices remained at strong levels. The Supplier Deliveries Index softened but continued to reflect suppliers' difficulties in maintaining delivery rates. All 10 of the subindices were positive for the period; a reading of 'too low' for the Customers' Inventories Index is considered a positive for future production A reading above 50 percent indicates that the manufacturing economy is generally expanding; below 50 percent indicates that it is generally contracting. The overall economy grew for the 19th consecutive month, according to the nation's supply executives in the latest Manufacturing ISM® *Report on Business*®. Based on historical relationships between PMI and GDP, a PMI of 58.7 corresponds to a 4.4% increase in real gross domestic profit (GDP) on an annualized basis.

Home prices remained high in October. According to the S&P Case-Shiller Home Price Indices home prices in October rose 19.1% over the last 12 months which is down 0.60% from the previous month's 19.7%. Phoenix, Tampa, and Miami had the largest year over year increases with 32.3% for Phoenix followed by 28.1% for Tampa and 25.7% for Miami. According to the National Association of Realtors, the year over year change in existing home sales was 6.9% in November for Single family homes between $250,000-$500,000 and housing supply continued to remain tight in September with 2.2 months of supply.

Markets: The markets are hitting all-time highs (All time high S&P 500 January 3rd 2022 at 4,796.5). At this time, the market is being driven by the hope of more fiscal spending, hawkish monetary policy, inflation, interest rates, and some actual fundamentals.

Covid-19 Virus: We have recently seen a resurgence in virus cases due to the new Omicron variant. As we continue to work to get on the other side of the virus and the economy returns to normal capacity, equity markets should benefit from low interest rates and the tail wind of all the economic stimulus we have received. The acronym TINA (There is no alternative) will remain.

- **Earnings growth for the SP500 is expected to increase 21.7% for the 4th quarter 2021. If the actual increase for the quarter is 21.7%, it will mark the fourth straight quarter of earnings growth above 20%.** According to FACTSET, of the SP500 companies that have reported earnings as of January 7th (approximately 20), 75% reported earnings above the mean estimate, and 90% have reported sales above the mean estimate. Looking at future quarters, analysts project earnings growth for the 1st QTR 2022 to be 6.3% and the full year of 2022 to come in at 9.4%.
- **While valuations remain stretched, we believe we can sustain these levels with the economic recovery, low interest rates, and improving corporate profitability.** ***Earnings growth will slow after being above 20% for the last 4 quarters.*** The current 12-month forward Price to Earnings is 21.2 we do not see a lot of room for valuations to move higher without growth. Lower interest rates allow for higher multiples, so we could maintain these higher levels of P/E's until interest rates return to meaningful levels.
- **Short Term Interest Rates remain near zero, but the Fed will continue to accelerate the tapering of their bond buying programs and will raise short term interest rates multiple times in 2022.** The Federal Reserve dropped short term rates 1.50% in March of 2020 and launched multiple quantitative easing programs. Rates have since been left unchanged at a range between 0.0-.25%. The Fed continues to closely monitor developments and is prepared to adequately adjust plans. 10-year treasury started 2021 yielding .93%, ended the 1st quarter at 1.74%, ended the 2nd quarter at 1.45%, ended the 3rd quarter at 1.52 and ended the 4th quarter at 1.52%.

Forecast:

We think the biggest threats to the stock market are interest rates continuing to increase accompanied by runaway inflation, the Fed tightening monetary policy, tax increases, and the uncertainty presented by the Covid-19 virus variants. We think the SP500 will end the Q1 2022 between 4750 and 4850. At this juncture, we venture a guess that stocks will end the year somewhere between 6% and 8% for the year.

For the next six to twelve months, the Federal Funds rate will most likely increase from its current range of 0%-0.25% to .75-1.00%. **The 10-year Treasury which is currently priced at ~1.76 % should remain in a range between 1.70%-1.90% through the end of the 1st quarter.**

As always, we appreciate your continuing confidence in our firm. Please let us know if you have questions.

Julian F. Patton, Jr. CFA, CFP®, CAIA
Chief Investment Officer