ECONOMIC & INVESTMENT PERSPECTIVES

DECEMBER: YEAR-END RALLY; 2021 ANNUAL REVIEW

Figure 1: 12/31/2021 Returns (source: Bloomberg)

Conditional formatting: green (high) to red (low) for each time period

Bonds	ETF	Month	QTR	YTD	1YR	Current vs. 52-wk High	Current vs. 52-wk Low
US Aggregate Fixed Income	AGG	-0.4%	-0.1%	-1.8%	-1.8%	-3.5%	0.8%
Investment Grade Corp Bonds	LQD	0.0%	0.4%	-1.8%	-1.8%	-4.1%	3.6%
U.S. Treasury Bonds	GOVT	0.4%	0.9%	-1.1%	-1.1%	-2.6%	2.4%
20+ Year Treasury Bonds	TLT	-2.0%	3.2%	-4.6%	-4.6%	-6.3%	11.3%
Muni Bonds	MUB	0.0%	0.7%	1.0%	1.0%	-1.5%	1.0%
High Yield	HYG	2.3%	0.8%	3.7%	3.7%	-1.3%	2.0%
Non-US Corp Bonds	IBND	0.4%	-1.9%	-8.4%	-8.4%	-10.1%	1.6%
Emerging Markets Bond LC	EMLC	1.2%	-2.9%	-9.7%	-9.7%	-14.6%	1.5%
Global Equity							
ACWI Global Equity	ACWI	3.9%	7.0%	18.7%	18.7%	-1.6%	18.3%
United States	VTI	3.8%	9.1%	25.7%	25.7%	-1.0%	27.2%
International Developed	EFA	4.4%	2.8%	11.5%	11.5%	-4.4%	9.3%
Emerging Markets	EEM	1.5%	-1.6%	-3.6%	-3.6%	-16.2%	3.6%
Global Equity by Region							
United States	VTI	3.8%	9.1%	25.7%	25.7%	-1.0%	27.2%
Europe	IEUR	5.1%	5.2%	16.7%	16.7%	-3.2%	15.1%
Asia ex-Japan	AAXJ	1.2%	-0.8%	-5.7%	-5.7%	-19.3%	3.6%
China	MCHI	-3.0%	-6.4%	-21.7%	-21.7%	-35.7%	4.0%
Japan	BBJP	2.4%	-3.5%	1.2%	1.2%	-11.0%	1.6%
Latin America	ILF	5.5%	-5.4%	-13.5%	-13.5%	-27.9%	3.9%
US Equity							
US S&P 500	IVV	4.6%	11.1%	28.8%	28.8%	-0.9%	30.3%
NASDAQ 100 QQQ	QQQ	1.2%	11.3%	27.4%	27.4%	-2.7%	33.8%
US Large Growth	IWF	2.0%	11.7%	27.4%	27.4%	-2.0%	34.8%
US Large Value	IWD	6.3%	7.8%	24.9%	24.9%	-0.6%	25.5%
US Eqwt S&P 500	RSP	6.3%	8.9%	29.4%	29.4%	-0.7%	30.6%
US Mid Cap	IJH	5.1%	8.0%	24.7%	24.7%	-3.1%	26.2%
US Small Cap	VTWO	2.2%	2.1%	14.8%	14.8%	-9.1%	16.6%

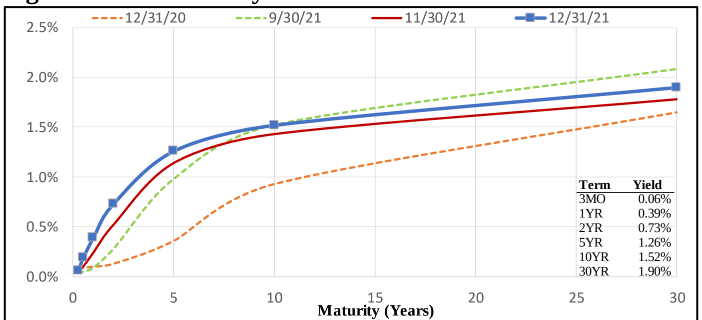
Stocks rebounded strongly in December despite rising virus infection rates and persistent inflation concerns. After a volatile month, U.S. equities ended the year within 1% of all-time highs. Performance highlights for December and the fourth quarter (Q4) are summarized below. A review of 2021 is presented on page 2.

- Bonds: The U.S. Aggregate index (AGG) fell 0.4% for the month as interest rates rose (-0.1% Q4). Long-term Treasuries (TLT) lost 2.0% in December but gained 3.2% in Q4 as the yield curve flattened (short-term rates rose but long-term rates declined – see Figure 2). Corporate bonds (LQD) were flat (+0.4% Q4) while high yield bonds rose 2.3% (+0.8% Q4) as credit spreads narrowed. Non-U.S. bonds (IBND and EMLC) rose in December but lagged in Q4 as the dollar strengthened.
- Global equity (ACWI): +3.9% in December (+7.0% in Q4).
- US Equity: The broad market (VTI) gained 3.8% this month (+9.1% Q4). The S&P 500 ETF (IVV) was up 4.6% (+11.1% Q4), out-performing small caps (VTWO), which rose 2.2% (+2.1% Q4). Growth stocks (IWF, QQQ) under-performed in December but logged the best Q4 returns. All sectors were up last month, and all but one (communications) gained in Q4.
- Non-U.S. Equity: Developed markets (EFA) gained 4.4% (+2.8% Q4), led higher by European stocks (IEUR), which rose 5.1% (+5.2% Q4). Emerging markets (EEM) under-performed (+1.5% in December, -1.6% in Q4) with continued weakness in China (MCHI -3.0% in December, -6.4% in Q4) amid concerns regarding potential new regulations and real estate debt.

Interest Rates and the Economy

Figure 2 graphs the US yield curve, which plots yields (Y-axis) for various maturities (X-axis) of U.S. Treasuries. Yields rose across the board in December with the increasing likelihood of Fed rate hikes beginning in 2022 to combat inflation. The yield curve flattened in Q4 as short-rates rose but long-term yields declined, reflecting fears of slowing economic growth amid renewed virus concerns and the potential impact of tighter Fed policy. The benchmark 10-year bond yield ended the year at 1.52%.

Figure 2: US Treasury Yield Curve

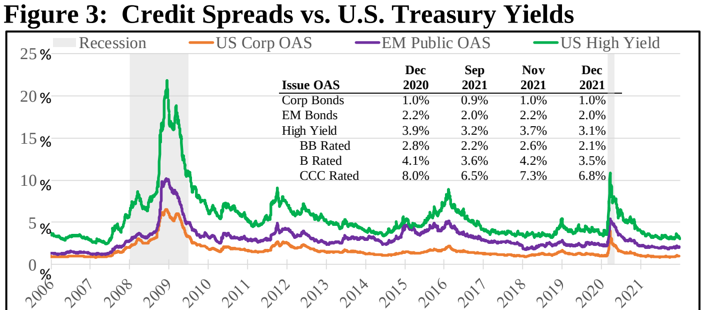


Source: Board of Governors of the Federal Reserve System via FRED

For bonds other than US Treasuries, we track the option-adjusted spread (OAS) between yields and Treasuries of comparable maturities. Low or narrowing spreads signal optimism while high or rising spreads signal fear. Spreads widened in November reflecting the risk-averse market tone but narrowed again in December.

- Investment grade corporate bond spreads have been stable at approximately 1.0% throughout 2021.
- High yield (non-investment grade) spreads narrowed to +3.1% and are well below year-ago spreads of +3.9%. The riskiest bonds (rated CCC & below) now yield +6.8% over Treasuries, down last month and below spreads of +8.0% one year ago.
- Emerging market bond spreads narrowed to +2.0% and are below 2020 year-end levels. Though these credit spreads have been relatively stable, non-U.S. bonds have under-performed U.S. bonds due to the strength of the dollar.

Figure 3: Credit Spreads vs. U.S. Treasury Yields



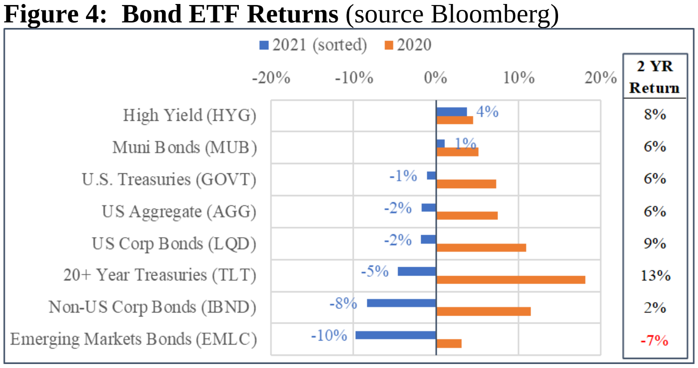
Source: Ice Data Indices, LLC via FRED

2021 & Pandemic Era Market Review

Despite the lingering struggle against new COVID virus variants, global economies recovered in 2021, and stocks surged. Gains were especially strong in the U.S., even as the Fed pared its bond-buying program and forecast interest rate hikes beginning in 2022 as they start to normalize monetary policy to address elevated inflation. The next three figures summarize 2021 and "pandemic era" returns across various stock and bond markets and segments, proxied by liquid ETFs. Each figure is constructed the same way, with 2021 total returns (blue bars and returns, sorted best to worst) and 2020 returns (orange bars) for context; the cumulative return for the two-year period is included in a panel inset.

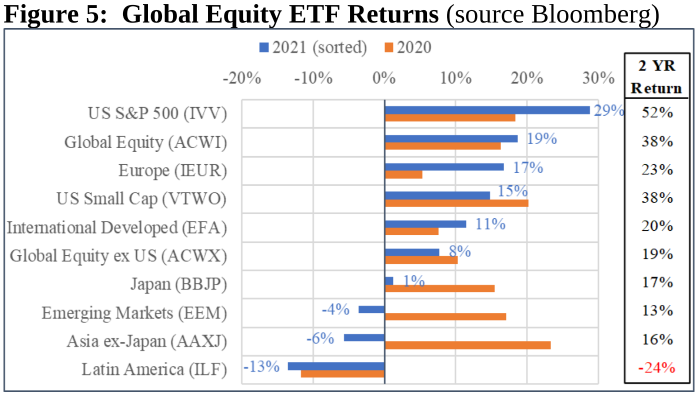
Figure 4 (below) plots the performance of various bond market index ETFs, illustrating the distinctly different interest rate regimes in 2020 (falling interest rates amid pandemic and economic uncertainty) and 2021 (rising interest rates with economic recovery and inflation). Most fixed income instruments lost value in 2021 as interest rates rose, partially offsetting strong returns in 2020. Over the full period, long-term Treasuries generated the best fixed income returns, while non-U.S. bonds fared poorly.

Figure 4: Bond ETF Returns (source Bloomberg)



By contrast, global equity (ACWI) soared in 2021, rising 19% on average, building on strong 2020 returns. As shown in Figure 5. U.S. stocks have led global markets higher. The S&P 500 (IVV) rose 29% in 2021 and is up 52% in the pandemic era! Non-U.S. stocks (ACWX) rose just 8% in 2021 (+19% two-year return).

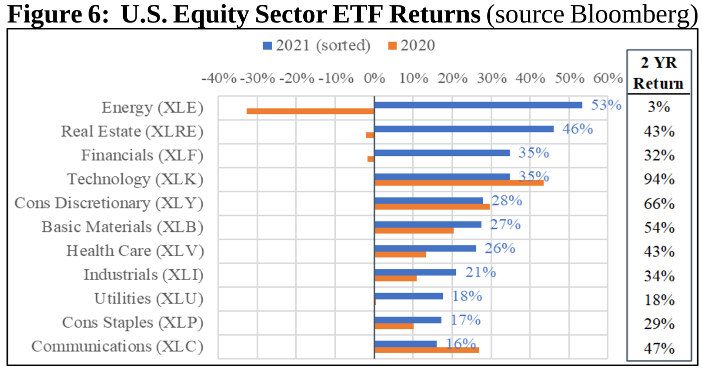
Figure 5: Global Equity ETF Returns (source Bloomberg)



Developed market stocks have posted solid gains over the past two years, with European stocks (IEUR) gaining 23% and Japanese equities (BBJP) up 17%. Emerging market equities have not fared nearly as well. Latin American stocks (ILF) lost more than 10% in both years (-24% total in two years), led lower by Brazilian stocks which lost about one-third of their value amid political scandals and a brutal struggle with the virus. Asian equities outside of Japan (AAXJ) struggled in 2021 largely due to weakness in China due to a growth slowdown and steady drumbeat of negative headlines regarding the potential for tighter regulation of e-commerce companies as well as struggling, debt-laden real estate development industry. Interestingly, China equities were flat for the full, two-year period, logging excellent returns in 2020 (MCHI +28%), then falling hard in 2021 (MCHI -22%).

U.S. equities have been led higher by large, growth-oriented stocks. Figure 6 (below) illustrates the strong but divergent performance of U.S. stocks across economic sectors. Energy stocks (XLE) were the best performers in 2021, rising 53% on average as the price of oil went from $48 to $75 per barrel (+56%%), but the sector was the worst performer in 2020 as oil prices collapsed; over the entire, two-year period the total return of the energy sector was just 3%, the worst sector-level return. The technology sector (XLK) has been the consistent winner, gaining 44% to lead all sectors in 2020 and rising another 35% in 2021; in total, the tech sector has gained an astounding 94% in the pandemic era!

Figure 6: U.S. Equity Sector ETF Returns (source Bloomberg)



Bottom Line

Investors have been spoiled with extraordinary returns in the past two years despite the lingering effect of the pandemic on the global economy. Gains have been powered by aggressive monetary and fiscal stimulus in the U.S. and around the world. Going forward, these tailwinds are likely to become headwinds as the Fed and other central banks wind down accommodative measures and "normalize" policy by raising interest rates. Additionally, elevated inflation has diminished the appetite for debt-financed government stimulus, especially in the U.S. What had been a synchronized global downturn in the wake of the pandemic has morphed into an unsynchronized recovery, with individual economies, markets, stocks and bonds rising or falling based on differing economic conditions (stimulus or lack thereof, inflation, interest rates, economic and earnings growth).

The emergence of the Omicron virus variant reminds us that we are not out of the woods yet. Continued progress against the virus is critical to global health and economic growth. Going forward, key economic and investment themes include the following:

- Pandemic: Vaccinations and variants;
- Fiscal and Monetary Policy: Withdrawal of stimulus.
- Inflation: Persistent or transitory?
- Aging Business Cycle: The rapid economic recovery and a flattening yield curve suggest mid-cycle economic activity with expectations of Fed tightening and lower future growth.

Markets are likely to remain volatile, underscoring the value of a diversified portfolio that over-weights liquid inflation hedges (equity, emerging markets, commodities).

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