MarketPoint

An Economic & Market Commentary from Trust Point

Fourth Quarter 2021 | Issue No. 36

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An Economic and Market Update from Trust Point

In 2021 we saw a year of fast economic growth. So fast, in fact, that inflation became a growing concern as we approached year-end. Fueled by the continuing re-opening process and huge amounts of stimulus, demand easily outstripped supply, creating a positive environment for equities. Bonds (with the exception of inflation-linked bonds) didn't do as well. To learn more about what 2022 may bring, please read on.

KEY ECONOMIC DATA	As of	Actual	3 Mos. Ago	1 Year Ago
Dollar Index Level	Dec	95.7	94.2	89.9
US Economic Activity				
ISM Manufacturing (>50 = Expansion)	Dec	58.7	61.1	60.5
ISM Non-Manufacturing (>50 = Expansion)	Dec	62.0	61.9	57.7
Non-Farm Payrolls	Dec	199k	379k	-306k
Unemployment Rate	Dec	3.9%	4.7%	6.7%
CPI Ex-Food & Energy (yoy)	Nov	4.9%	4.0%	1.6%
Global Economic Activity				
JP Morgan Global Manufacturing Index (>50 = Expansion)	Dec	54.2	54.1	53.8
JP Morgan Global Services Index (>50 = Expansion)	Dec	54.6	53.8	51.8

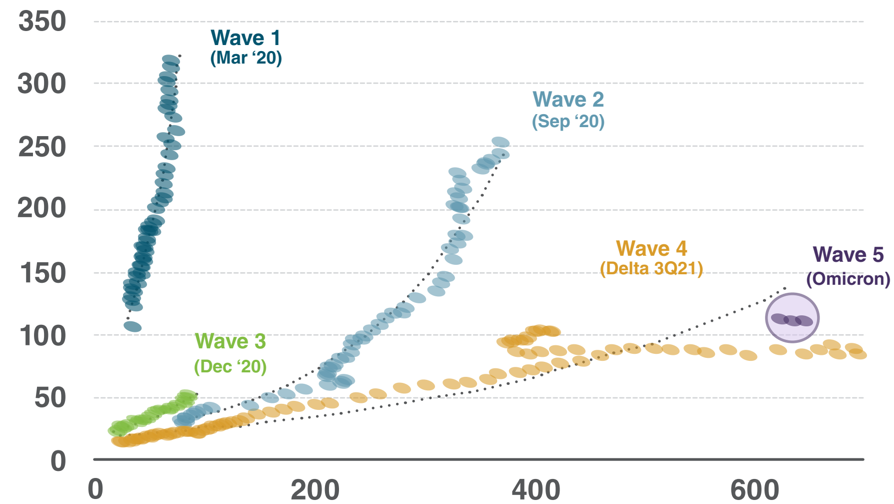
Source: Bloomberg

Omicron: More Contagious but Less Lethal

The new COVID-19 variant is spreading rapidly. Just like Delta displaced Alpha, we are now seeing Omicron rapidly displacing Delta. The good news is that Omicron appears to cause less severe health issues and hospitalizations than other variants did (Chart 1). The bad news is that Omicron is highly contagious (at least 3 times more so than the Delta variant, which makes it similar to measles). Because Omicron clearly has the potential to infect so many more people so quickly, some hospitals could still be overwhelmed as large numbers of sick (mostly unvaccinated) people look for care all at once. Under this scenario, renewed restrictions on mobility would clearly be possible, which could impact economic activity. Even if we would expect restrictions to be targeted and short-lived in most countries, the uncertainty surrounding the pandemic means that the risks around our economic forecasts will continue to be larger than normal.

Chart 1: Hopitalizations per Case Should Remain Low

UK new Covid-19 cases (x-axis) vs. hospitalizations (y-axis)



Source: Oxford University, Vanda

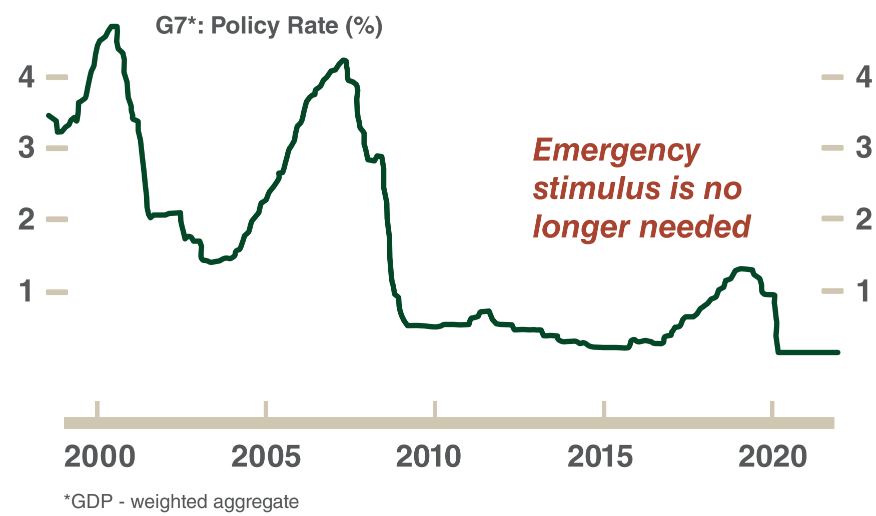
Strong but Slowing Economic Growth in 2022

Despite some potential short-term impacts on economic activity in the early part of 2022 due to Omicron, we still expect growth to remain above trend next year, driven by excess savings, pent-up consumer demand, strong business investment, and inventory rebuilding. As central banks continue to lag the recovery, in our opinion growth is likely to remain above potential even in 2023. One of our core themes in 2021 was that the global authorities had purposely divorced the policy cycle (monetary and fiscal) from the economic cycle by providing very large amounts of stimulus early and repeatedly, which led to equities and other risk assets front-running the improvement in economic fundamentals. In some ways, our market outlook for 2022 is dictated by how the partial removal of stimulus affects the macroeconomic environment (and asset prices), as recent inflation data has now forced the hands of policymakers to adopt a more hawkish attitude towards stimulus. Our thesis remains that the underlying conditions supporting the recovery are intact and stronger than generally perceived. As a result, we continue to expect both growth and inflation to remain above trend in 2022 while central banks continue to play catch up (Chart 2).

Outlook on Stocks and Bonds

From a portfolio positioning standpoint, we remain pro-equities for now, mostly reflecting our more bearish bond stance. Unfortunately, the backdrop for government bonds remains challenging as robust macroeconomic conditions and the beginning of tightening monetary conditions may prove to be a headwind for high-quality, interest-rate sensitive bonds in 2022. In our opinion, the greatest mispricing in the bond market is at the long end of sovereign yield curves, as investors bet on the continuation of the secular decline in long-term bond yields and the low growth/low inflation environment of the 2010s. Our recommendation is to stay maximum underweight in government bonds and short duration in fixed income while favoring high-yield bonds, emerging market debt, and inflation-linked bonds. Equities, on the other end, have further upside on a 6-to-12-month basis, but the path will be more volatile and more modest gains should be expected as higher valuations (Chart 3) limit the extent of future price appreciation. Within equities, we expect a greater shift in 2022 towards better-valued equity laggards that are levered to the economic cycle, and as a result we are maintaining a strong bias towards value stocks, small caps, and select non-U.S. equity markets.

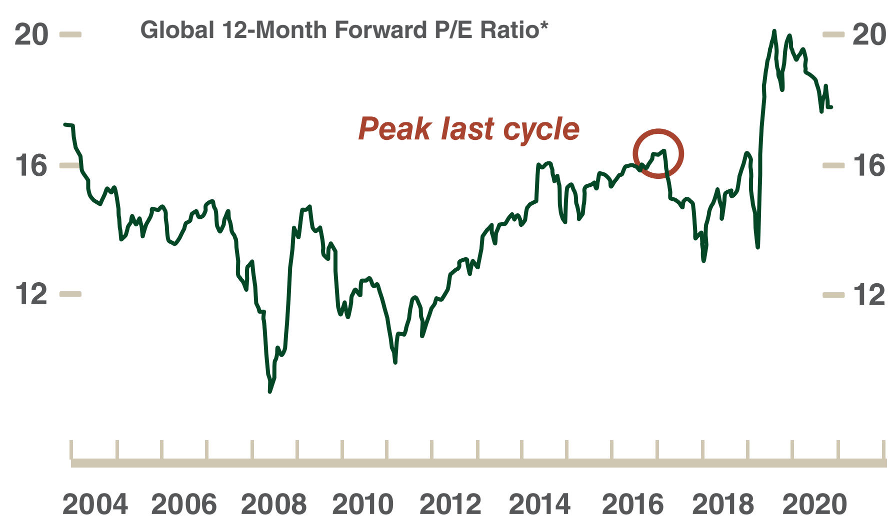
Chart 2: Policy Rates: Still at Historically Low Levels



*GDP - weighted aggregate

Source: MRB Partners

Chart 3: Higher Valuations: A Potential Headwind for Equities



Source: MRB Partners

An Equity Market Update from Trust Point

In Q4, the S&P 500 index surged 11.0% while the MSCI ACWI ex-US index increased 1.8%, respectively. The pandemic (and its threat to sustaining higher economic growth expectations), inflation concerns, and an unexpected hawkish turn from the Federal Reserve were the biggest market drivers over the past quarter.

EQUITY BENCHMARK TABLE

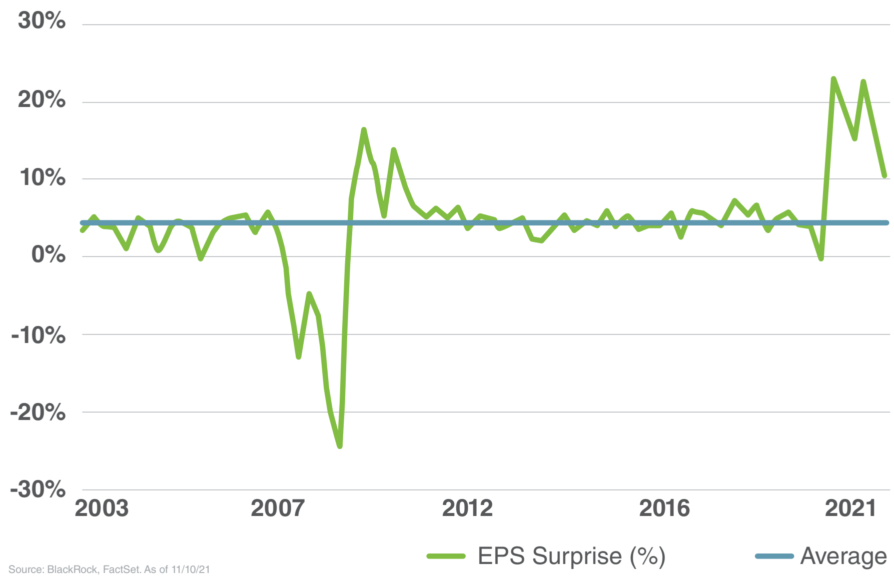
US Economic Activity	Quarter-End	3 Mos. Ago	1 Year Ago	3 Years Ago	5 Years Ago
S&P 500	4,766	4,308	3,756	2,507	2,239
Dow Jones Industrial Average	36,338	33,844	30,606	23,327	19,763
NASDAQ	15,645	14,449	12,888	6,635	5,383
Equity Returns (%)	3 Month	YTD	1 Year	3 Year (Ann)	5 Year (Ann)
US Large Cap Growth	11.6%	27.6%	27.6%	34.1%	25.3%
US Large Cap Value	7.8%	25.2%	25.2%	17.6%	11.2%
US Mid Cap Growth	2.8%	12.7%	12.7%	27.5%	19.8%
US Mid Cap Value	8.5%	28.3%	28.3%	19.6%	11.2%
US Small Cap Growth	0.0%	2.8%	2.8%	21.2%	14.5%
US Small Cap Value	4.4%	28.3%	28.3%	18.0%	9.1%
International Large Cap Developed (US Dollar)	2.7%	11.3%	11.3%	13.5%	9.5%
International Small/Mid Cap Developed (US Dollar)	0.1%	10.1%	10.1%	15.6%	11.0%
Emerging Market (US Dollar)	-1.3%	-2.5%	-2.5%	10.9%	9.9%

Source: Bloomberg, Morningstar

Can Earnings Momentum Continue?

Behind the news headlines that can drive investment emotions and behaviors are fundamentals like corporate earnings, the central driver of stock prices over the long term. This quarter, the market experienced yet another strong earnings reporting season as Q3 results, once again, largely came in well ahead of consensus expectations. Companies have been able to demand higher prices, put in place to offset higher wages and higher costs due to supply constraints. As a result, profit margins were maintained and, in many cases, even reached record highs. This also led to future earnings estimates to be revised ever higher. However, as we look into 2022, one of the challenges investors will face is to determine the sustainability of these earnings trends (Chart 4). Forward earnings optimism will be tested by economic growth expectations that have recently moved lower from COVID variant persistence and tougher year-over-year earnings growth comparables. That said, we still generally expect a solid earnings growth environment. At the sector level, we believe the primary areas of opportunity exist in the U.S. Financials sector, which should still have earnings upside from a likely increase in long-term bond yields that help bank profit margins. Regionally, international markets still offer great value and an attractive play on above-trend economic growth.

Chart 4: S&P 500 Earnings Surprise Relative to Consensus Expectations

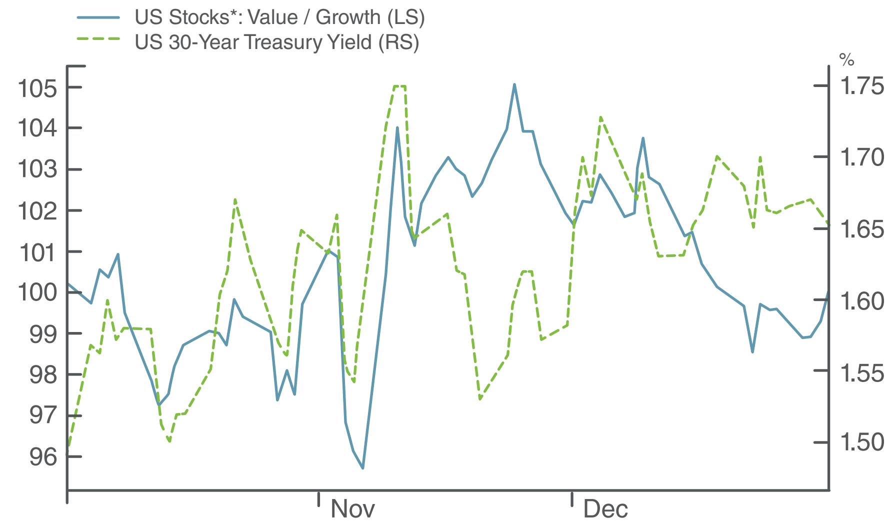


Source: BlackRock, FactSet. As of 11/10/21

Sector Rotation Still Trying to Rotate

As COVID variants rose during the back half of the year, investors once again sought out the relative safety of US and growth stocks (i.e. Technology sector). Value stocks performed in-line with their Growth counterparts in Q4 (Chart 5) as global economic growth concerns increased the possibility of lockdowns, particularly internationally, though some of those concerns seemed to abate on the margin in the last few days of the year. Growth stocks, on the other hand, continued to perform well (despite trading at high valuation multiples) as they are largely able to grow revenue and earnings in spite of economic conditions. While economic growth expectations have moderated recently, they remain well-above trend. As a result, we still believe a bias towards Value stocks, and away from Growth stocks, is the right positioning over the next 6-12 months. While Omicron could provide volatility through the winter months, each successive wave is appearing to have diminished economic impacts as vaccination rates increase globally. Above-trend economic growth in 2022 could easily push long-term bond yields higher in 2022 which should be a positive catalyst for Value stocks.

Chart 5: Global Value Stocks Performed In-line with Growth Stocks in Q4



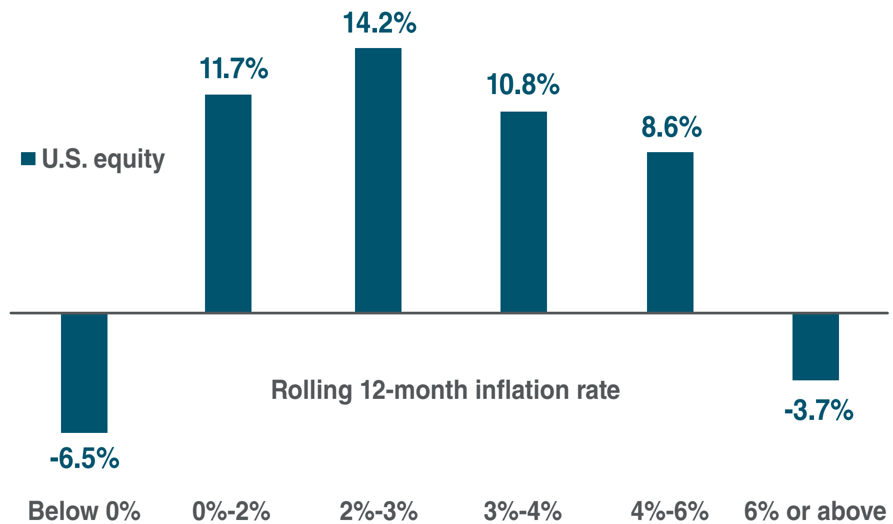
*Rebased to Jan 1, 2021 = 100

Source: BCA Research, 10/1/2021-12/31/2021

Inflation and Stocks

While inflation is a concern and a source of equity volatility, stocks tend to be the most compelling choice among the major asset classes to hedge against it. The relationship between inflation and stocks can primarily be broken down two ways. First, stocks have tended to perform well during inflationary periods (Chart 6) as companies have historically been able to pass along higher prices to customers thereby protecting, or even expanding, margins (too high of inflation, however, could cause customer demand to slow and earnings multiples to contract). The second point is inflation's impact on different types of stocks. While higher inflation may cause general volatility within equity markets, value stocks tend to outperform growth stocks in an inflationary environment. As central banks typically raise short-term rates to contain inflation, higher rates tend to boost the performance of financial stocks while compressing multiples of expensive technology and consumer discretionary stocks. The message here is simple: maintain exposure to stocks during inflationary periods, and ride out volatility with a diversified portfolio that emphasizes exposure to stocks that benefit from rising interest rates.

Chart 6: Stocks Have Performed Well in Various Inflation Environments



Source: Capital Group, Bloomberg, Morningstar, Standard & Poor's. For periods 1/1/70 – 11/30/21 of the S&P 500 Index. Inflation rates are defined by the rolling 12-month returns of the Ibbotson Associates SBBI U.S. Inflation Index.

A Fixed Income Market Update from Trust Point

In the fourth quarter, bonds faced similar headwinds to those seen over the course of 2021. Throughout the quarter, upside surprises in inflation prints put upward pressure on bond yields. Other than the Omicron-induced "flight to safety" trading in late November/early December, central banks tightening and a renewed focus on inflation dominated sentiment. The net effect was slightly negative returns from global bonds for the quarter and the year.

FIXED INCOME BENCHMARK TABLE

US Yields (%)	Quarter-End	3 Mos. Ago	1 Year Ago	3 Years Ago	5 Years Ago
3 Month T-Bill	0.0%	0.0%	0.1%	2.4%	0.5%
2 Yr US Treasury	0.7%	0.3%	0.1%	2.5%	1.2%
10 Yr US Treasury	1.5%	1.5%	0.9%	2.7%	2.4%

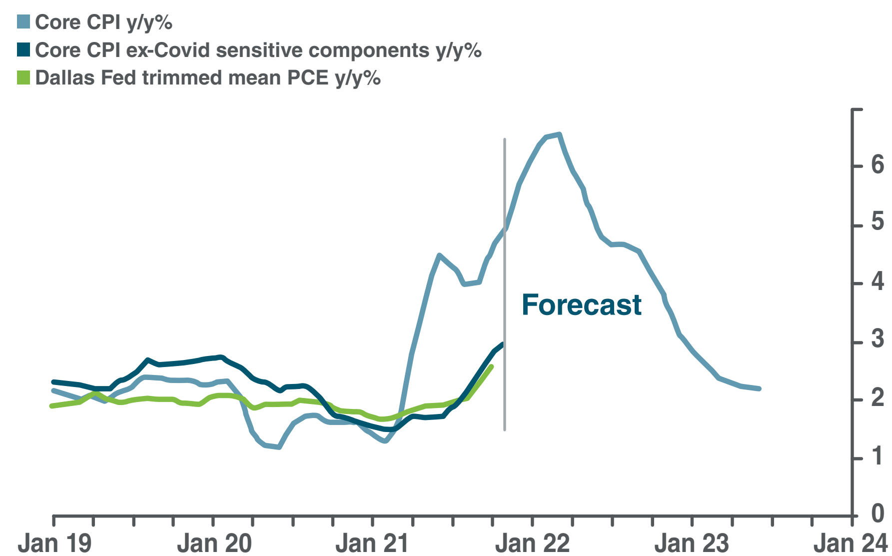
Global Economic Activity	3 Month	YTD	1 Year	3 Year (Ann)	5 Year (Ann)
US Intermediate Treasuries	-0.2%	-3.0%	-3.0%	4.4%	3.3%
US Treasury Inflation Protected Sec.	2.4%	6.0%	6.0%	8.4%	5.3%
US Mortgages	-0.4%	-1.0%	-1.0%	3.0%	2.5%
US Short-Intermediate T/E Munis	0.1%	0.4%	0.4%	3.3%	2.9%
US Investment Grade Corporates	0.2%	-1.0%	-1.0%	7.6%	5.3%
US Senior Bank Loans	0.7%	5.2%	5.2%	5.6%	4.3%
US High Yield	0.7%	5.4%	5.4%	8.6%	6.1%
Int'l Bonds Ex-US (Hedged)	0.2%	-2.1%	-2.1%	3.3%	3.1%
Int'l Bonds (Unhedged)	-0.7%	-4.7%	-4.7%	3.6%	3.4%
Emerging Market Debt (US Dollar)	-0.0%	-1.5%	-1.5%	6.1%	4.5%

Source: Bloomberg, Morningstar

Inflation Has Exceeded Market Expectations This Year

Inflation continued to broaden in the fourth quarter with November U.S. consumer price inflation hitting 6.8%, near a 40-year high. U.S. core CPI rose to 4.9% and is expected to rise further in the first half of 2022 (Chart 7). The upside-surprise readings in last month's CPI reports showed both an acceleration in inflation momentum and a broadening of inflationary pressures. This pressure finally forced Federal Reserve Chair Jerome Powell to admit that "it's probably a good time to retire the word transitory." This is consistent with our view, as we have been positioned for more resilient inflation than the Fed was indicating. At roughly 39% of the core CPI, the increase in rent prices was the largest in 15 years (Chart 8). Wage growth is another component which is rising quickly. As wages pick up, services spending rises and companies raise prices to offset higher costs. In the services-based U.S. economy, both wage growth and rents play a large role as price increases in these areas are slow to reverse, creating a more persistent inflationary environment. Inflation is no longer isolated to pandemic-related goods impacted from supply disruption or reopening sectors such as leisure and hospitality. We have been positioned well as the market has begun to recognize and acknowledge this shift.

Chart 7: U.S. Core CPI is likely to Rise Further in the First Half of 2022



Source: Pantheon Macro

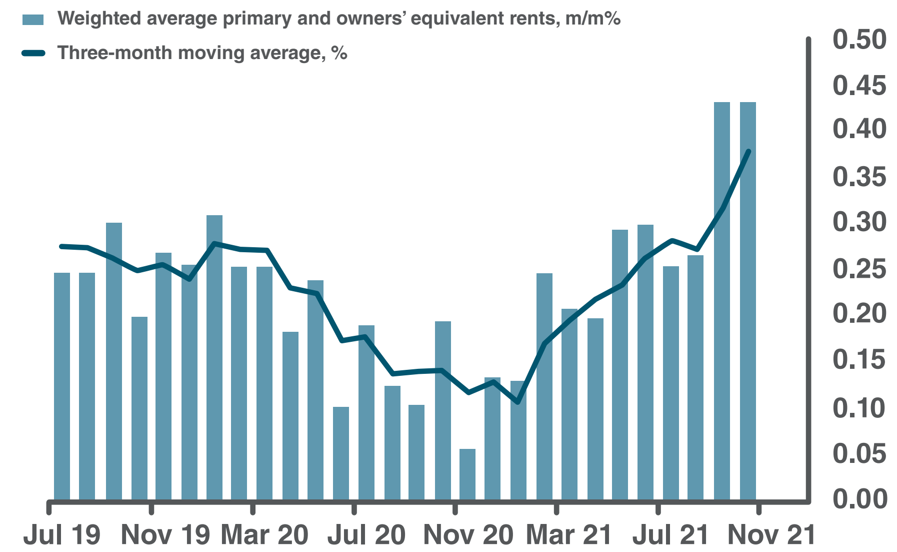
Fed Pivots to Inflation Fighting

In mid-December, Powell signaled the Federal Reserve's desire to normalize monetary policy faster than what was expected earlier in the year. This was the first step in a long process of policy tightening, but was a major pivot from earlier communication. The Fed will double the speed of reducing asset purchases with an end date of March instead of June. In addition, the committee signaled to the market that it intends to hike the Fed Funds rate three times over the next year, to a range of .75%-1.0% (Chart 9). As we had predicted, the Fed's view that the rise in inflation was "transitory" became tougher to defend as broader inflation measures continued to challenge that outlook. With underlying inflation set to stay uncomfortably high for the foreseeable future, we believe this policy shift and recognition of persistent inflation was a much-needed course correction after a year of the Fed ignoring these inflation risks. Although the timing or number of rate hikes per year may change based on underlying data, we believe the level of inflation will remain stronger and more persistent than the Fed expects next year. Barring further COVID outbreaks or negative growth shocks, this will be enough to keep the Fed on its current path to higher rates in 2022.

What This All Means for Portfolios

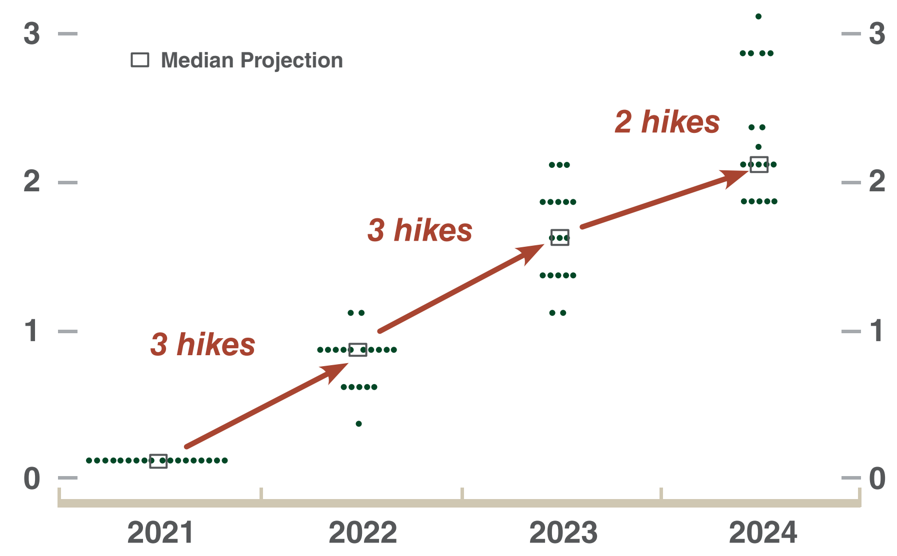
The risk/reward profile for high-quality government bonds remains poor. An extended period of extremely accommodative central bank policies has left government bond yields at very low levels; even negative levels in some foreign developed nations. With higher inflation forcing central bank policy changes, we continue to believe the diversification benefits of Treasuries remain challenged. We have little dedicated exposure to government bonds but still find value in portfolio inflation protection. This has been a rewarding trade in 2021. We also continue to maintain less interest-rate sensitivity in portfolios relative to the overall market. Our exposure to credit markets and other fixed income sectors which are tied to improving corporate health and a strong economy have continued to provide diversification benefits while enhancing portfolio yield. We remain cautiously optimistic in these areas and will be closely monitoring corporate health and profitability going forward. Trust Point fixed income portfolio returns were positive in 2021 in an environment in which broad market indices were mostly down on the year. We expect our positioning to pay off again next year but remain flexible to adapt to changing market conditions.

Chart 8: Rental Pricing Pressures are Likely to Support Persistent Inflation



Source: Pantheon Macro

Chart 9: Median FOMC Projections Signal Rate Hikes on the Horizon



Source: U.S. Federal Reserve, MRB Partners

Key Investment Themes

Macroeconomics

- Structurally, **D**ebt, **D**emographics, and **D**eglobalization may influence global growth and inflation for years
- **Cyclically, growth will remain strong in 2022 (policy support, vaccine availability and pent-up demand)**
- Structurally, greater policy support and healthier consumers & banks (vs the 2010 decade) will lead to better growth
- **Biggest wild card: Inflation + Covid Variants**

Asset Allocation

- **Tactically, the risk/reward outlook favors stocks vs bonds**
- **Low bond yields & pricier equity valuations call for modest returns from financial assets over the next 3-5 yrs**
- Global macro factors have important implications for various sub-asset classes / sectors
- Important to maintain a diversified approach and not let emotions dictate investment decisions

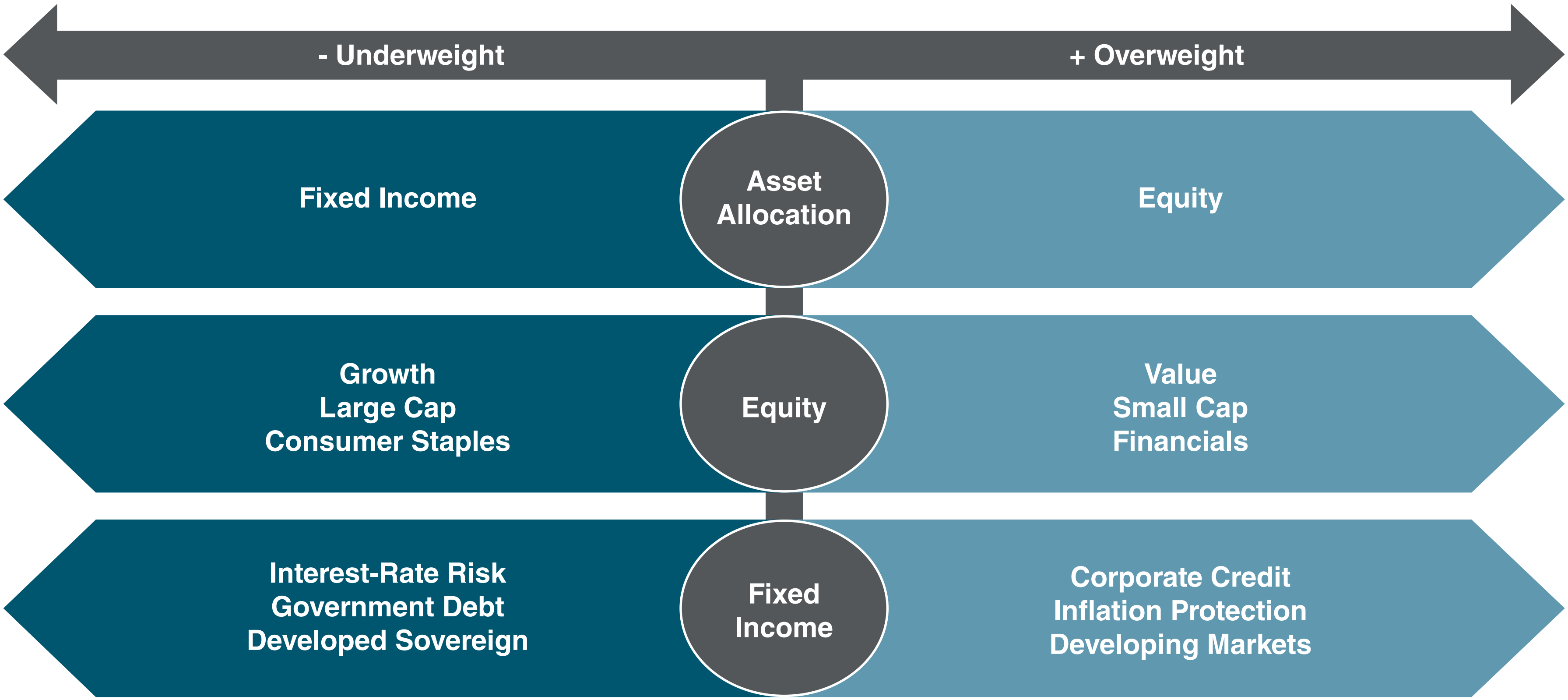
Fixed Income

- Government bond yields are historically low. They do not offer attractive value for long-term investors
- **Expect steeper yield over the short-term but an overall flatter curve medium-term as Central Banks reduce commitments to keep short-term rates low.**
- LT pressure on the U.S. dollar favors some unhedged international fixed income exposure
- **Strong growth and continued policy support will allow defaults and spreads to stay low/tight. Favor credit**

Equities

- **Equities continue to benefit from policy support, strong earnings and the "lack of alternatives"**
- Volatility has subsided as investors get more clarity on the outlook going forward
- 2021 earnings have been strong and have led to ongoing upward revisions of forward earnings estimates
- **Small-cap, value and int'l stocks offer good value in a strong cyclical expansion**

Tactical Asset Allocation



Profile Summary

In the fourth quarter we maintained our overweight position to equities relative to fixed income. The equity portion of portfolios have maintained a bias toward cyclical, small cap and value sectors of the economy which have benefited from broadening economic growth due to the combination of widespread vaccinations, easy monetary policy and fiscal stimulus. We continue to favor corporate credit within fixed income portfolios as credit is directly benefiting from easy monetary policy and low interest-rates. We also maintained our inflation hedges and positioning for further yield curve steepening. We continue to position portfolios to ensure that we can provide the best risk-adjusted returns without taking unnecessary risks.

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MarketPoint

Market Point is a quarterly market commentary designed to provide you with an overview of economic conditions, as well as equity and fixed income market summaries for the quarter.

This commentary is offered by the Investment Management team. The individuals contributing to Market Point are pictured from left to right: Randy Van Rooyen, CFA®, Yan Arsenault, CFA®, CAIA®, Ryan Bergan, MBA, Steve Brudos, Brandon Hellenbrand, CFA®, Brett Sebion, Christine Doll and Nolan Gaffney. Please feel free to contact any team member with questions.

       

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