
# GW & Wade's Q4 2021 Economic & Market Commentary

**2021 PERFORMANCE**

| U.S. Equities | | Global Equities | | Fixed Income | |
|---|---|---|---|---|---|
| Index | % | Index | % | Index | % |
| S&P 500 | 28.71 | MSCI ACWI | 18.54 | BB Global Aggregate | -4.71 |
| DJIA | 20.95 | MSCI EAFE | 11.26 | BB US Aggregate | -1.54 |
| Russell 2000 | 14.82 | MSCI EM | -2.54 | | |

Source: Morningstar, YTD Returns through 12/31/21.
Past performance not indicative of future results.

## Economy

The U.S. economy has continued to grow and add jobs at a strong pace, making steady progress towards the Federal Reserve's goal of maximum employment. But supply constraints—both bottlenecks and labor shortages—have had a larger and more persistent effect on the economy than anticipated. Due to the collision between those supply constraints and strong demand, inflation pressures have become more widespread and may last longer into 2022 than first thought. The economic recovery should continue, but the risks that supply constraints may limit job gains and economic output growth have increased, and inflation could complicate the Federal Reserve's management of monetary policy in 2022.

Inflation has escalated substantially this year, along with a significant rise in inflation expectations. Despite the highest wage gains in years, inflation in 2021 has wiped out any real wage increase for the average worker. Upward price pressures, no longer concentrated in a few categories, appear to have broadened. There has been a notable increase in the prices of energy, food, goods, and services, as well as the cost of owning a home.

These pressures are related to both supply constraints and strong demand. Wages have continued to grow quickly on a more sustained basis than they have in more than 20 years, most recently reflected in a striking increase in the employment cost index. Wages and employment costs have been widespread across industries and businesses of varied sizes. Crucial to the path of inflation will be whether the input cost increases are consistently reflected in final goods prices consumers pay.

After the Delta variant and supply chain problems threw the U.S. economy off its strong growth path in the third quarter, it seemed we were returning to strong growth in the fourth quarter. As a society, we continued to learn how to manage and adapt to the virus with vaccines, boosters, and ever-improving treatments. But now, the Omicron variant has rapidly circled the globe, closed borders, and sparked new restrictions on economic activity. Yet central banks, instead of loosening monetary policy to prop up their economies as they did at the start of the pandemic, have moved to unwind stimulus and raise interest rates. Central bank officials worry that rather than simply threatening to curtail economic growth, a surge in COVID-19 cases could also prolong high inflation with a return to demand for goods and away from services amidst continued supply chain disruptions.

## Outlook

U.S. GDP growth in 2021 is expected to come in at 5.8%. If realized, that would mark the fastest GDP growth since 1984. Looking forward, real GDP growth will likely downshift to about 4.5% in 2022, which is still an above-trend rate of growth.

Real disposable personal income soared to record levels in early 2021 on the wings of stimulus checks. As fiscal support waned, traditional sources like wages and salaries have replaced stimulus as the main driver of income growth.

Despite recent material strides in the labor market, the total number of jobs has stayed 3.9 million below its pre-pandemic peak. Demand for labor has rebounded faster than supply, with workers gaining more sway. Prime-age workers' participation rate has increased as younger workers take advantage of pay bumps in entry-level jobs. But older workers' participation has remained low, and many of them are unlikely to return to the labor market anytime soon.

Goods inflation drove this year's historically high inflation, while services inflation has faced near-term pressures from shelter price increases and new demand after Delta-related weakness. Inflation will get worse before it gets better but should subside over the first half of 2022. Still, a return to levels consistent with the Fed's long-run goal of 2% is not likely in 2022.

The Fed will likely start raising interest rates in the second quarter of 2022. Fed rate hikes will not restore clogged supply chains, but they could prevent long-run inflation expectations from becoming unmoored.

At this point, it is still too early to know the full extent to which the Omicron variant will change the public health scenario and weigh on economic activity. The COVID-19 virus has been less devastating economically with each subsequent wave to date. But the next few months will be crucial to shaping projections as public health experts learn which aspects of the variant are similar and different from what has been encountered previously.

## Market Developments

2021 was another stellar year for U.S. equities, while most bond sectors turned in negative returns as interest rates began to rise, from what now appears to be more persistent intermediate-term inflation. As has been the story for the past decade, U.S. large-cap equities outpaced both smaller cap domestic stocks, as well as international and emerging market equities. The strength of the record bounce-back in corporate profits, a pickup in corporate stock buybacks, and continued strength in the U.S. dollar were tailwinds pushing returns along.

However, there was a vast disparity in equity returns across the globe in 2021 as economic performance and central bank policies varied. U.S. economic growth and corporate profits reached multi-decade record levels while the Federal Reserve maintained its highly accommodative policy stance through most of the year. In the U.S., the S&P 500 posted a 28.7% return while domestic midcaps and small caps as measured by Frank Russell Company returned 22.6% and 14.8% respectively. The MSCI EAFE (European, Australian, and Far East Index) returned 11.3%, while the MSCI Emerging Markets Index posted a -2.5% return. The MSCI Europe returned 16.3%, while the MSCI Japan posted only a 1.7% return. Among large Emerging Equity markets, India posted the highest return at 26.2%, while the lowest was posted by China with a -21.7% return.

In the U.S., double-digit gains were posted by every economic sector. The lowest returns were posted by more defensive “always necessary” sectors like Utilities and Consumer Staples while Energy (54.7%), Real Estate (46.2%), and Financials (35.1%) were the three best performing sectors. In large caps, growth slightly outperformed value with a strong finishing kick to the year, while in midcaps and small caps, value outperformed growth in each capitalization band by over 10% in 2021.

Market volatility in the U.S. continued to come down from the extreme volatility brought on by the onset of the pandemic in the first quarter of 2020. Lower volatility is associated with greater investor confidence and higher market prices. While overall that was true, several events during the year (e.g., the emergence of the Delta and Omicron COVID-19 variants) spooked investors, caused short-term spikes in volatility, and created conditions for a retreat in market prices. In hindsight, these dips turned out to be short-term buying opportunities as the underlying strength of the U.S. economy and strong corporate profits dominated temporary headline-grabbing events.

## Market Outlook

As has been the case for almost two years, the course and trajectory of the pandemic continued to be a major influencer of worldwide economic behavior. As infections, hospitalizations, and deaths increase, restrictions and lockdowns soon follow. That rapid and unplanned curtailment of "normal" economic behavior (like travel, leisure, dining, and other service-related businesses) had immediate and often sudden impacts on business in those industries (e.g., airline flight cancellations) and the industries in the supply chain feeding those industries. It impacts the bond market and level of market interest rates as well. As stated earlier, these sudden changes have precipitated stock market volatility, representing buying opportunities. These declines in the market have been accompanied by short-term dips in interest rates as confidence temporarily eroded for growth prospects.

However, the important backdrop to the global stock rally has been driven by strong, above-trend economic growth and record levels of corporate per-share earnings growth. It is expected that corporate earnings growth will continue to be strong in 2022 but not at 2021 levels. This is because earnings growth in 2022 will be compared to earnings in 2021, and those comparisons, while attractive, will be lower and maybe only half or less than what was achieved in 2021 vs. 2020. With that said, it will be no surprise if U.S. equity performance comes in lower than in 2021 if, for no other reason, corporate profits will decline. 2023 should offer more of the same in terms of lower equity returns and lower corporate earnings growth on the heels of slowing economic growth.

There appears ample difference of opinion of what will happen in the bond market in 2022 and beyond. What does appear certain is that the U.S. dollar will remain strong relative to foreign currencies given both relative economic performance comparisons, the anticipated rise in interest rates, and the potential rise of the entire yield curve. This strength will continue to attract foreign capital seeking safe and rising yields. What remains a quandary, however, is why the bond market in 2021 as a whole appeared unconvinced that inflation posed a structural or more permanent problem for investors. Long-term interest rates have remained low though they fluctuated between about 1.2%-1.7% for the benchmark 10-year U.S. Treasury in 2021. This may change, but bears close watching as the Federal Reserve shifts monetary policy to a less accommodative stance in 2022.

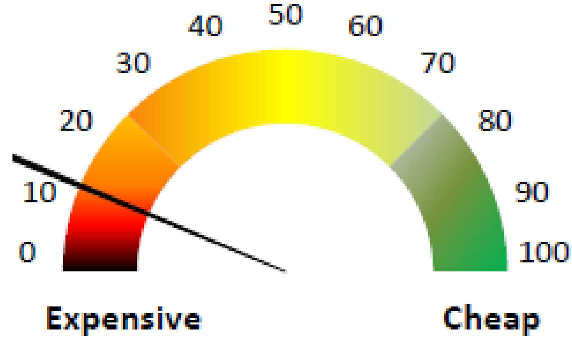
There remains a litany of other factors that will impact earnings, stock, and bond prices that cannot be forecast but we should keep in mind. First is what will the Federal Reserve do with interest rates? They have signaled their bond-buying program will end in March, which *should* take some of the downward pressure off long-term interest and mortgage rates. Since their policy decisions are data-dependent, what if inflation continues to run "hotter" than they expect? Will they feel compelled to have a 50 bps hike in 2022 rather than only 25 bps increases, or could there be four hikes next year rather than three? This kind of surprise for the market could prove disruptive though the Fed would likely signal their inflation concern in advance to not shock impact investor psychology.

And there are other influential factors including, the gradual healing of supply chain issues, the absence of new stimulus money into household bank accounts as savings are drawn down, the 2022 mid-term elections, and the rate of wage increases drawing people back into the workforce, etc. Needless to say, there are plenty of potential influences that will have a bearing on how the stock and bond markets perform this coming year.

As much as we try to resume normal life, the data does suggest vaccines, treatments, and our collective experience have helped us develop a better working knowledge about how to manage our way through life with the virus in our communities. 2022 should in theory be a period when we can put all this to work in more effective ways than was possible just 12 months ago.

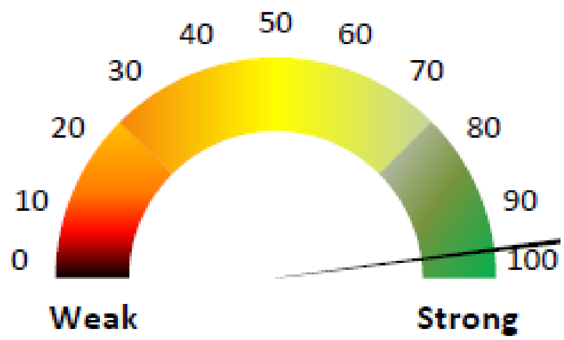
We will continue to monitor the progress of the Build Back Better bill and communicate if anything may impact your financial situation. If you have any questions, we encourage you to contact your GW & Wade Counselor or you can reach us at **info@gwwade.com**.

# Equity Valuation




Based on the S&P 500 trailing twelve-month Price-to-Earnings ratio, our gauge of U.S. equity valuation registers a current reading at the 13th percentile from January 1957 to December 2021.

# Economic Activity




Based on the Federal Reserve Bank of Philadelphia's U.S. Coincident Index, our gauge of U.S. economic activity registers a November 2021 reading at the 96th percentile from April 1979 to November 2021.

*The equity valuation and economic activity gauges have been reviewed by GW & Wade and are consistent with the firm's near-term outlook.*

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Investing in securities, including investments in mutual funds and ETFs, involves a risk of loss which clients should be prepared to bear, including the risk that the full investment may be lost. There is no guarantee that you will not lose money or that you will meet your investment objectives.

About the indices presented above:

- Standard & Poor's 500 (S&P 500®) Index is a market capitalization-weighted index of 500 common stocks chosen for market size, liquidity, and industry group representation to represent U.S. equity performance.
  The Dow Jones Industrial Average (DJIA) is a price-weighted average of 30 significant stocks traded on the New York Stock Exchange (NYSE) and the Nasdaq.
- The Russell 2000 Index measures the performance of the small-cap segment of the U.S. equity universe. It includes approximately 2,000 of the smallest securities based on a combination of their market cap and current index membership.
- The MSCI ACWI (All Country World Index) is a market capitalization-weighted index designed to provide a broad measure of equity-market performance throughout the world.
- The MSCI EAFE Index is an equity index that captures large and mid-cap representation across Developed Markets countries around the world, excluding the US and Canada.
- The MSCI Emerging Markets Index (EM) captures large and mid-cap representation across 24 Emerging Markets (EM) countries.
- The Bloomberg Barclays Global Aggregate Bond Index measures global investment grade debt from twenty-four local currency markets. This multi-currency benchmark

includes treasury, government-related, corporate and securitized fixed-rate bonds from both developed and emerging markets issuers.
- The Bloomberg Barclays US Aggregate Bond Index measures the performance of the U.S. investment-grade bond market. The index invests in a wide spectrum of public, investment-grade, taxable, fixed-income securities in the United States – including government, corporate, and international dollar-denominated bonds, as well as mortgage-backed and asset-backed securities, all with maturities of more than 1 year.
- The Bloomberg Barclays US Credit Index measures the investment grade, US dollar-denominated, fixed-rate, taxable corporate and government-related bond markets. It is composed of the US Corporate Index and a non-corporate component that includes foreign agencies, sovereigns, supranationals and local authorities.
- The Bloomberg Barclays US Corporate High Yield Bond Index measures the USD-denominated, high yield, fixed-rate corporate bond market. Securities are classified as high yield if the middle rating of Moody's, Fitch and S&P is Ba1/BB+/BB+ or below. Bonds from issuers with an emerging markets country of risk, based on Barclays EM country definition, are excluded.

Views expressed are as of the date indicated, based on the information available at that time, and may change based on market or other conditions. GW & Wade assumes no duty to update any of the information presented above.

Clients of the firm who have specific questions should contact their GW & Wade Counselor. All other inquiries, including a potential advisory relationship with GW & Wade, should be directed to:

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