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Quarterly Economic Commentary

By Jim Watts, Senior Portfolio Manager

	12/31/2020	12/31/2021	%Gain/Loss
Dow	30,606	36,338	20.90%*
S&P 500	3,756	4,766	28.70%*
NASDAQ	12,888	15,645	22.20%*

*Total Return Including Dividends

2021 Recap

Despite the challenges in 2021, the stock markets performed extremely well.

Energy was the top performer - up 54.6%
Real Estate - up 46.2%
Financials - up 35.0%
Utilities - up 17.7%
Consumer Staples - up 18.6%
Industrials - up 21.1%

2021 was a tough year for the fixed income markets. The 10-year Treasure was down 3.6%, ending the year with a yield of 1.50%. Corporate bonds were down 1.5%, but Muni bonds were up 1.5%.

2022 Outlook

The outlook for 2022 is "all over the board", depending on who you ask. Regardless of who you ask, it seems that most will agree the majority of stocks are above fair value. There are several factors that seem to be on the forefront for how the market performs in 2022.

Valuation Concern

The long-term trend in the U.S. stock market has been higher. In the 40-plus years since Ronald Reagan became president in 1980, stocks have turned in a positive performance almost 85% of the time. The average annual gain has been 13%. The S&P 500 has risen pretty sharply the past three consecutive years. Over the past 10 years, there was one down year which was 2018. Depending on the index that you look at, the market was off between 2% to 4.5%. There were two years of low, single-digit, positive returns and the other seven years have been significant double-digit returns.

Inflation

The Fed has decided to "retire" the term transitory inflation, saying they believe inflation is embedded in the economy. They have increased the pace of tapering, which means that interest rate increases will begin sooner than anticipated a few months ago.

Demand

Despite rising costs from materials, components, labor and transportation, demand continues to exceed supply. This allows companies to increase prices and pass those costs along to consumers. This will drive company valuations (stock prices) higher as long as companies can price up their products and services.

Reopening Trade

There has been an ever-changing landscape of shut-downs, mask mandates, COVID-19 variants, virtual versus in-person and travel restrictions. Once we get past these, or at least see significant improvement, the economy should see another boost in consumer spending. People have experienced "cabin fever" for nearly two years and they are ready to get out, eat out and travel.

Midterm Elections

Of the four years in a presidential term, the second year (the midterm election year) has been one of the worst for investors. Since 1980, returns in the second year of a presidential term have averaged 5.6%, compared to average returns for 14.4% and 15.8%, respectively, in years 1 and 3. The likely reason is uncertainty. Investors favor continuity, and a mid-term election offers a real opportunity for a change in direction. We also note that the incumbent parties typically lose seats in mid-term elections. The loss of a few Democratic seats in either Senate of the House could tip the chamber to the Republicans. The odds of a Republican-controlled House are currently 5-1, but a lot can happen over the next 11 months.

Geopolitical Landscape

Markets have strongly advanced over the past few years, but it seems now more than ever, they are very fragile. While Russia threatens to invade the Ukraine, China threatens to invade Taiwan and Iran continues to advance its nuclear ambitions, it's clear that any one of these could tip the equity markets into a correction or even a bear market.

2022 Expectations

The Fed is in the process of tapering and we expect it to be completed in March. We anticipate three rate hikes this year, starting in May or June, again in September and finally in December. We anticipate that the 10-year Treasury yield will be in the 2- 2.25% by the end of 2022. Just like with the equity markets, certain issues could derail these expectations, with the biggest issue being another more contagious, more deadly variant of Covid-19.

In summary, we expect the **stock market** to be more volatile and the returns much more subdued, hopefully producing a mid-single digit return. We think **interest rates** will rise with at least three 0.25% increases, beginning right around mid-year and we expect that **inflation** will continue to be an issue and possibly cause the economy to stall. While **supply chain** issues will persist, we believe that higher price pressures will help resolve this problem.

We appreciate each client's uniqueness and will always strive to do what is best for each individual client. Please do not hesitate to ask us questions or express your concerns. This is your money and we are your stewards.

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