Beacon Trust
INNOVATING WEALTH STRATEGY

Market Outlook 4Q 2021 Review **January 5, 2022**

Fourth Quarter Summary

Santa Claus did arrive on time to spur a fourth quarter rally for the S&P 500, capping off a stellar year for domestic equities. The S&P 500 increased 11.1% in Q4 and 28.7% for the full calendar year, including reinvested dividends. Growth outpaced Value for the fourth quarter (+13.2% vs. 7.7%) and calendar year (27.4% vs. 25.1%), as measured by the Russell 1000 Indexes. Bonds had a rare losing year as longer term interest rates increased, with the benchmark Bloomberg Barclays Aggregate Index down 0.1% for the quarter and 1.8% for the calendar year.

Speaking of interest rates, it was an active quarter for the Federal Reserve. First, President Biden removed some uncertainty by renominating Jay Powell to a second term as Fed Chair, as well as putting forth Lael Brainard for Vice Chair. Both nominations should get through Congress without too much trouble. The Fed provided greater clarity on ending its quantitative easing program and its timeline for raising interest rates. The emerging consensus is that the Fed's bond buying program will end in March. Subsequently, a rise in the Federal Funds Rate is in play, with a near term increase a possibility if inflation continues to surge. The most recent print on the CPI was an eye popping 6.8%, the highest since the early 1980s.

We look forward to the day when COVID-19 is a distant memory, but the delta and now omicron variants of the virus have led to continued delays in a full reopening of the global economy. In parallel, the global supply chain problems and shortages have contributed to the elevated inflation numbers. The White House trumpeted the passing of the Bipartisan Infrastructure Deal (Infrastructure Investment and Jobs Act) in Q4, which focuses on expenditures related to bridges, roads, tunnels, plumbing, and broadband. However, their "social infrastructure" package (Build Back Better Act), which was expected to include funds for combatting climate change as well as large subsidies for pre-school education, dental and vision benefits in Medicare, and mental health services, has stalled in Congress, with Democratic Senators, Joe Manchin and Kyrsten Sinema, threatening to nix the pricey package. Our view is that a slimmed down version of the package will be passed before the November midterm elections, but we are closely following developments and their investment implications.

Market Outlook

The market's favorite lady, TINA, an acronym which stands for There Is No Alternative, is likely still the theme for 2022. In other words, when investors look at their menu of possibilities, making sizeable allocations to cash and investment grade debt when inflation is above 6% seems quite unappealing. Heightened U.S. stock market valuations, with the S&P 500 trading at roughly 20x forward earnings, rising interest rates, and moderating earnings growth may limit the potential for stock market gains in 2022. Our base case is for returns in the mid-single digits, but there may be more upside if the Fed can unleash a "goldilocks scenario" of taming inflation without severely hampering economic growth by aggressively hiking interest rates. Better returns may occur for international equities since many countries lagged the U.S. in tackling the COVID-19 pandemic and they are starting at more reasonable valuations.

Our view is that interest rates will gradually rise across the entire maturity spectrum as the year unfolds. Long-term rates have already started to move, with the benchmark 10-Year U.S. Treasury Note currently at 1.7%, up from 1.4% just two weeks ago. As noted earlier, we expect the Fed to start hiking short-term interest rates between the end of Q1 and Q2. Our forecasted range of the 10 Year Treasury Note is 1.5% to 2.5% over the course of the year, with the odds stacked towards above the midpoint.

Volatility was remarkably benign last year, with the biggest intra-year drawdown reaching only 5% in 2021. We would be delighted to have a similar tranquil environment for equities in 2022, but are not counting on it. The primary risks for 2022 are similar to the ones we ended the year with - COVID, China, Russia, inflation, and interest rates. It seems like the world is going to have to grapple with the fact that COVID-19 is going to be with us for a long time. Battling the pandemic will take a multitude of forms on a global scale, including vaccinations, pharmaceuticals, personal protection equipment, and social distancing. A growing consensus is that we cannot afford, either financially or emotionally, to lockdown entire countries as we did during the early stages of the pandemic. The U.S.-China relationship will play out over the coming decades, but there may be a brief détente as Beijing gets ready to host the Winter Olympics next month.

The Russia-Ukraine crisis is unresolved, with Russia drawing a "red line" that Ukraine must not be admitted into NATO. The U.S. and its Allies continue to have a dialogue with Russia, threatening sever economic sanctions in the event of an invasion. The current situation reminds us of the Cuban Missile Crisis from the 1960s. If there is an invasion, it may result in a stock market correction, but offer the potential for a quick recovery once the economic damage is assessed.

Inflation and interest rates are joined at the hip. Our view is that the Fed is behind the curve on its tightening policy and that inflation will continue to be well above the Fed's 2% target. However, we believe that inflation will eventually get to more palatable levels as the year progresses, as supply chains become unsnarled, the pandemic recedes, demographic spending patterns take root, and the proliferation of technology drives down costs. All of us at Beacon wish you and your family a happy and healthy 2022.

John M. Longo, PhD, CFA

Chief Investment Officer, Portfolio Manager

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