Shearwater Creek Investment Matters

4th Quarter 2021 Market Update

2021: Year 2 of COVID-19 Pandemic

4th Quarter 2021 Review:

Stocks posted solid gains in Q4, overcoming a late-November sell-off in reaction to the global spread of the omicron variant. For 2021, the S&P 500 Index was up +28.71% (including dividends) leading all U.S. equity indexes while the Nasdaq 100 and Dow Jones Industrial Average were up +21.39% and +20.95% respectively. Small-cap stocks rose +14.82% for 2021. Corporate profit growth slowed from its blistering pace in the 1st half of the year but remained robust as roughly four out of five companies in the S&P 500 beat consensus earnings estimates, the fourth-highest percentage since FactSet began tracking the data in 2008.

High inflation readings weighed on fixed income which was flat overall in Q4. For 2021, the Bloomberg U.S. Bond Aggregate declined -1.54%, representing the first negative return for bonds in many years. In late November, Fed Chair Jerome Powell told a congressional committee that he no longer thought it was appropriate to refer to inflation as “transitory.” CPI rose +6.8% in the 12 months ended in November, the biggest increase since 1982. Producer prices also jumped +9.6%, the largest increase since 2010. Inflation also worried consumers as well. In November, the University of Michigan’s consumer sentiment index fell to its lowest level in a decade, with many respondents citing rising prices.

In November, the Fed took its first step toward tightening by cutting its monthly purchases of U.S. Treasury and mortgage-backed bonds by $15 billion and accelerated the pace of tapering in December and January. Policymakers now expect three rate hikes in 2022, followed by five more hikes over the next two years, lifting the expectation for fed funds to 2.1% at year-end 2024.

Following a slowdown in the 3rd quarter, consumer spending and employment data accelerated in Q4. Nonfarm payrolls grew at a healthy clip through October then decelerated in November, but the slowdown appeared to be due to a labor supply shortage rather than demand. Job openings hit 11mm, the highest on record and the unemployment rate fell to a pandemic-era low of 4.2%. In December, weekly jobless claims fell to their lowest level since 1969.

News of the omicron variant also weighed heavily on consumer sentiment. Thankfully, as the quarter came to an end, investors seemed reassured that the variant appeared to cause milder illness and seemed to have peaked rapidly in South Africa where it was first discovered. The approval of two new pill-based treatments for those seriously ill with COVID-19 also calmed fears, as did the CDC's announcement that they were cutting its quarantine guidance from 10 days to five days.

European equities posted strong gains as investors expect only gradual tightening in monetary policy. The European STOXX Europe 600 Index was up roughly +7.25% for Q4 and +22% on the year. The European Central Bank (ECB) left its main policy rates unchanged but said it would stop buying assets under its Pandemic Emergency Purchase Program in March, 2022 while temporarily expanding another bond-buying program to smooth the transition. ECB President Christine Lagarde said later that an interest rate increase in 2022 was "very unlikely."

Several European countries tightened social restrictions for the end-of-year holiday season including travel bans, mandatory vaccination for health workers and the use of passes reflecting the bearer's vaccination status for access to entertainment venues. The Netherlands and Austria introduced lockdowns in November.

Asian markets underperformed as political uncertainty in Japan and slowing growth in China weighed on sentiment. The Nikkei 225 Index declined (-2.24% in Q4. For the full year 2021, the MSCI Japan Index finished up +2.04. While other major central banks took steps to normalize policy, the Bank of Japan (BoJ) is considering further easing steps to support the economy through the pandemic. The BoJ is among the world's most dovish central banks.

Chinese stocks posted negative returns for 2021 as the MSCI China Index lost -21.64%. China eased its monetary policy in Q4 amid a nationwide property market slowdown. The People's Bank of China cut its reserve requirement ratio by 50 basis points effective December 15, its second such move in 2021.

Hopes for a thaw in U.S.-China relations following a November virtual summit between U.S. President Biden and China's Xi Jinping evaporated as both sides escalated investment restrictions on each other. In November, the Biden administration said it would extend a Trump-era ban on U.S. investments in Chinese companies that it deems are owned or controlled by China's military, then added a dozen Chinese companies to its trade blacklist later in the month. In December, President Biden signed a bipartisan bill that effectively bans U.S. imports from Xinjiang province. For its part, China issued a flurry of new regulations on overseas share sales by domestic companies.

2022 Outlook:
After back-to-back years of strong equity performance across most sectors, global markets face more uncertain prospects in 2022. Inflation, a shift toward monetary tightening and new coronavirus variants all pose potential challenges for equity markets. Many believe that economic growth inevitably will slow sharply as governments and central banks withdraw the stimulus applied during the pandemic.

However slower growth doesn't necessarily mean low growth. There are a number of tailwinds that can sustain the economic recovery into 2022:

■ U.S. consumers currently hold over $2 trillion in checking accounts and other short-term deposits.

■ Asset appreciation has significantly increased household wealth both in the U.S. and globally.

■ Pent-up demand for housing should continue to fuel new home construction.

■ Corporate balance sheets generally are in strong shape, with high liquidity and low debt ratios.

■ Transportation bottlenecks appear to be easing as seen by a sharp drop in global shipping costs.

Unless pandemic conditions deteriorate significantly, improving global supply chains and factory re-openings could ease the upward price pressures in 2022. Much of the 2021 inflation surge was concentrated in specific products especially used cars and gasoline. The hefty price hikes in these goods seen in 2021 are unlikely to be repeated in 2022. In terms of equity valuations, much depends on the strength of earnings growth in an environment where the spread of coronavirus variants and the potential for rising interest rates both pose significant if contrary risks to the global economic recovery.

Here's a performance recap of major market indexes for Q4 and the full year 2021:

Equity Indexes:

	Q4 2021	2021
S&P 500	11.03%	28.71%
Dow Jones Industrial Average	7.87%	20.95%
Nasdaq Composite (Principal Return)	8.28%	21.39%
Russell Midcap	6.44%	22.58%
Russell 2000	2.14%	14.82%
MSCI All Country World	6.77%	19.04%
MSCI Europe	5.72%	16.97%
MSCI Emerging Markets	-1.24%	-2.22%

Bond Indexes:

Bloomberg Barclays U.S. Aggregate	0.01%	-1.54%
Credit Suisse High Yield	0.63%	.50%

Note: Returns are for the periods ended December 31, 2021. The returns include dividends and interest income based on data supplied by third-party provider RIMES and compiled by T. Rowe Price, except for the Nasdaq Composite Index, whose return is principal only.
Sources: Standard & Poor's, LSE Group, Bloomberg Barclays, MSCI, Credit Suisse, Dow Jones, and J.P. Morgan (see Additional Disclosures).

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Sources: [1]Thomson Reuters. Past performance is no guarantee of future results. Yields may be lower or higher than quoted above. Yields fluctuate as market conditions change. An index is unmanaged and not available for direct investment. The indices are presented to provide you with an understanding of their historic long-term performance and are not presented to illustrate the performance of any security. Large Cap = S&P 500 Index (The S&P 500 index is weighted by market value, and its performance is thought to be representative of the stock market as a whole.), Mid-cap = Russell Midcap Index (The Russell Midcap Index measures performance of the 800 smallest companies (31% of total capitalization) in the Russell 1000 Index, with weighted average mark et capitalization of approximately $6.7 billion, median capitalization of $3.6 billion, and market capitalization of the largest company $13.7 billion.), Small-cap = Russell 2000 Index (The Russell 2000 Index is a small-cap stock market index of the bottom 2,000 stocks in the Russell 3000 Index.), DM Ex-U.S. = MSCI EAFE Index (The MSCI EAFE Index is a stock market index that is designed to measure the equity market performance of developed markets outside of the U.S. & Canada.), Emerging Markets = MSCI EM Index (The MSCI Emerging Markets Index is an index created by Morgan Stanley Capital International (MSCI) designed to measure equity market performance in global emerging markets.), Bloomberg Barclays U.S. Aggregate Bond Index (The Bloomberg Barclays US Aggregate Bond Index is a market capitalization-weighted index, meaning the securities in the index are weighted according to the market size of each bond type.), ICE U.S. Treasury 20+ Year Bond (The ICE U.S. Treasury 20+ Year Bond Index measures the performance of Treasury securities and is selected by a Market Value process.), Markit iBoxx USD Liquid High-Yield Bond Index (Consists of liquid USD high yield bonds, selected to provide a balanced representation of the broad USD high yield corporate bond universe. The index is used as a basis for tradable products, including ETFs.)

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