MARKET REVIEW & OUTLOOK

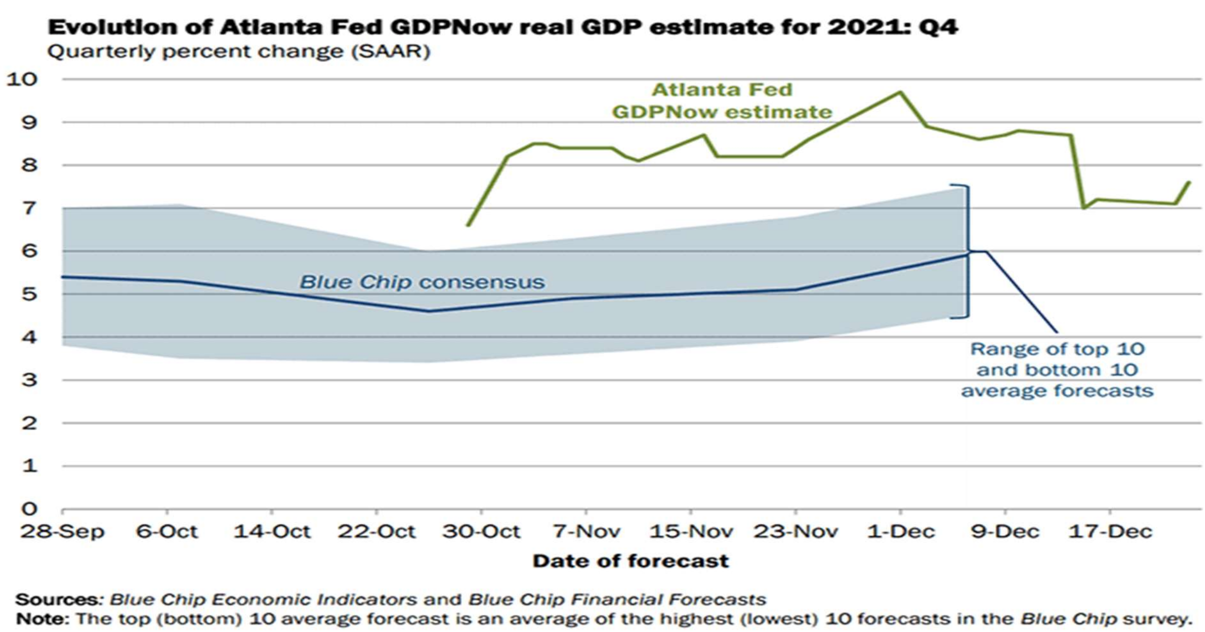
December 2021

KEY TAKEAWAYS

- The Omicron variant hit late last month and remained headline news throughout the month. December, off to a rough start with Omicron, bounced back, then had a mid-month slump but regained its footing to end near all-time record highs. Though the "riskier" asset classes of US Small Cap and Emerging Markets had rather modest gains.
- Interest rates followed a similar path to the larger equity indices, though rather than price, yields ended near the highs of the month. Even with equity volatility and the scare of Omicron, the Fed is holding tight to ending quantitative easing sooner, i.e., March 2022.
- D.C. got busy early in the month, with a continuing resolution for a 2-month budget extension and a 12 month, right after mid-term elections, extension of the debt ceiling. Then all eyes shifted to the Senate weighing in on Build Back Better and Senator Manchin, "killed" the bill. So, all the scary tax increases a lot of people were worried about won't be happening, at least for 2021.

The U.S. Economy

The final release for 3rd quarter GDP came in modestly higher, yet again, now at 2.3%. Now that 4th quarter has ended, we will soon get the first look at GDP for the last quarter of the year. I continue to feel this quarter was very similar to 3rd quarter minus the Omicron variant, which likely was net negative for economic growth. However, I seem to be the only one that feels that way as 4th quarter expectations remain high. Please see the chart below.



Source: https://www.frbatlanta.org/cqer/research/gdpnow

Stocks and Bonds

The fixed income markets traded in a wide choppy range as inflation remained strong, pushing yields higher, but the Omicron variant caused concerns about a potential growth slowdown, pushing yields lower. The December Fed meeting confirmed that quantitative easing is likely to end quicker than the original 6-month pace, i.e., March. Though the Fed signaled they would be data dependent, did anyone expect them to say anything different than they have the last 13 years?!?! 😉 The data dependence gave the market a sense of calm that we aren't on autopilot and yields drifted, but didn't sprint, higher. The overall increase in longer term base Treasury rates proved a headwind for high quality fixed income. The result for High-quality fixed income, as measured by the iShares US Aggregate Bond ETF, finished the last month of the year with a loss of -0.33%. The U.S. 10-year Treasury bond yield ended the month near the upper end of the range at 1.51%, up from November's close of 1.44%.

The Dow Jones Industrial Average jumped +5.38%, the S&P 500 rose +4.36%, and the small cap Russell 2000 increased +2.11%. The international markets traded in a similar fashion as the U.S. The MSCI EAFE iShares Core International Developed Markets ETF Index climbed +4.74%, and the MSCI Emerging Markets iShares Core ETF Index gained +2.19%.

In December, we saw green across the board, though led by "defensive" sectors.

The best performers were…

- Consumer Staples: +9.70%
- Real Estate: +9.33%
- Utilities: +8.83%
- Healthcare: +8.60%

The lagging performers were…

- Consumer Discretionary: +0.00%
- Energy: +1.67%
- Financials: +2.87%
- Technology: +3.05%

Source: https://www.sectorspdr.com/sectorspdr/tools/sector-tracker

Oil Report

The vicious sell-off in the energy complex on the initial reports of Omicron, eased as the apparent severity of the illness was far less than we had seen with previous variants. That's not to say the rally/recovery was all smooth sailing, but prices did firm up considerably from the initial lows. The demand scares quickly returned to a supply concern as hospitalizations and deaths have not escalated at near the pace of new cases. The current NYMEX WTI Crude Oil futures settled at $75.45 and posted a gain of 14% from the prior month close of $66.18 a barrel, though still well below October's close. The rebound in price for RBOB gasoline was equally strong as crude oil with a gain of over 14% vs November's close. So short of something unexpected, it looks like energy prices are going to remain firm with a tug-of-war between the strength of demand pitted against constrained increases in supply.

The Rest of the Data

The November ISM Manufacturing Index reversed last month's modest decline of 0.3 points with a gain of 0.3 points to 61.1 from October's reading of 60.8. Additionally, the ISM Services Index jumped to 69.1 in November from October's print of 66.7, vaulting to another all-time high. The prices paid component eased for both surveys, though remain at highly elevated numbers. Any reading above 50 generally indicates improving conditions. Consumer confidence increased to 115.8 in December, which compares to an upwardly revised figure of 111.9 in November. The unemployment rate dropped again, coming in at 4.2% and the economy added 210,000 jobs in November vs. consensus of 550,000 jobs, though at odds with a strong household survey. The Consumer Price Index for All Urban Consumers (CPI-U) was up +0.8% in November, "easing" modestly from last month, on a seasonally adjusted basis. Over the last 12 months, the All-Items Index increased to +6.8% on a non-seasonally adjusted basis, the highest since June 1982. The CPI ex Food and Energy, eased to 4.9% from last month's 5.3%. Overall, these numbers show an economy on solid footing with clear levels of higher inflation that are gaining steam, leaving little doubt that the march higher in inflation could no longer be viewed as transitory. The expected economic strength for 4th quarter along with inflationary pressure sees the end of Fed tapering bond purchases by March, with the interest rate market now pricing in the first-rate hike in May and 3 for the year 2022. We will be closely monitoring economic activity to see if the Fed is held to this schedule or forced to act even quicker.

Summary

The calendar has turned to a new year and what that will bring is anyone and everyone's guess. On the table we have potentially very strong reported growth for the 4th quarter along with inflation pressures at levels we haven't seen for decades. Additionally, the argument that with low interest rates, it is justifiable to have historically high valuations for the equity markets. However, if the first points hold and the fixed income market starts increasing base Treasury yields higher, does that not make the second point less valid and pressure equity markets at stretched valuations? Of course, how could we forget the corona virus and its various mutations and the potential impact on human and economic lives? With all that said, we enter the new year with as many moving parts and narratives as ever. On the next page is the Fed's "favorite" measurement/chart for evaluating inflation.

Source: https://www.zerohedge.com/personal-finance/us-producer-prices-explode-record-high-november-and-theres-worse-come

Looks like the Fed has some work in front of them. How they respond and how the markets react will be very important to monitor.

However, after digesting all of that, we retain our focus on what we can control, which is the amount of equity risk that is taken in a clients' portfolio in concert with the clients' risk tolerance and long-term goals. The markets will always face different "worries", today it is inflation vs. corona virus variants, tomorrow it will be something else. We have built our asset allocation models with dynamic features and quarterly rebalancing, both in fixed income and equities. If the markets continue to march higher, we will capture some of those gains and reallocate to less volatile high-quality bonds. If the equity markets enter a period of negative performance, we have dynamic investment vehicles that utilize rules-based defense mechanisms to reduce the risk of the portfolio. Further, if the market gets too extended on the upside, some of the vehicles will capture partial gains and wait for the extension to correct.

If you have specific questions about your portfolio or financial situation, we are here to help. Long-term financial planning is designed to deal with uncertainty like those we discussed above. Our portfolio management process is to design a prudent allocation across many asset classes. Equities are for long-term growth and several vehicles that we utilize offer defensive mechanisms to mitigate equity market declines.

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