Q4 2021 Commentary

January 2022

"We must accept finite disappointment, but never lose infinite hope."
– Martin Luther King, Jr.

Q4 MARKET RECAP

Developed market equities delivered strong returns in 2021 driven by improving fundamentals as the global economy recovers from pandemic driven disruptions. Buoyed by a strong consumer, U.S. corporations were able to grow margins in an inflationary environment while also increasing revenues and earnings at a rapid pace. Energy, U.S. REITs and financials were the best sector performers in 2021, not counting certain cryptocurrencies, with 54%, 46%, and 35% gains, respectively. Despite a brief lead by value midway through the year, growth equities ultimately outperformed value, while large caps outperformed small caps. Foreign developed equities underperformed U.S. equities yet again but did outperform their previous 35-year average by over 4.5%. Emerging market equities delivered a -2.5% return last year, primarily weighed down by underperformance in Chinese equities. It was a very challenging year for taxable fixed income investments as global investment grade bonds returned -4.7% while U.S. investment grade bonds returned -1.5%. Adjusting for inflation, these numbers represent the worst real returns since 1980. Municipal bonds performed relatively well and were up 1.5%. U.S. high yield and floating rate bonds performed well amidst rising rates as they returned 5.3% and 3.5% for the year.[1]

Asset Class	Benchmark	December	Q4 2021	YTD
U.S. Large Cap Stocks	S&P 500 TR USD	4.5	11.0	28.7
U.S. Small & Micro Cap	Russell 2000 TR USD	2.2	2.1	14.8
Intl Dev Stocks	MSCI EAFE NR USD	5.1	2.7	11.3
Intl Dev Small & Micro Stocks	MSCI EAFE Small Cap NR USD	4.4	0.1	10.1
Emerging & Frontier Mkt Stocks	MSCI EM NR USD	1.9	-1.3	-2.5
Global Stocks	MSCI ACWI NR USD	4.0	6.7	18.5
U.S. Municipal Bonds	Bloomberg Municipal TR USD	0.2	0.7	1.5
U.S. Taxable Bonds	BBgBarc US Agg Bond TR USD	-0.3	0.0	-1.5
U.S. High Yield Bonds	BBgBarc US Corporate High Yield TR USD	1.9	0.7	5.3
U.S. Bank Loans	S&P/LSTA U.S. Leveraged Loan 100 TR USD	0.8	0.4	3.5
Intl Dev Bonds	S&P International Sov Ex-US Bond TR USD	-0.5	-1.7	-9.5
Emergin & Frontier Bonds	JPM EMBI Global Diversified TR USD	1.4	-0.4	-1.8
U.S. REITs	MSCI US REIT NR USD	8.6	16.0	41.7
Ex U.S. Real Estate Securities	S&P Global Ex US REIT TR USD	4.8	4.7	13.5
Broad Commodity Futures	Bloomberg Commodity TR USD	3.5	-1.6	27.1
Energy Partnerships	Alerian MLP TR USD	3.6	0.6	40.2
Gold	DJ Cmmdty Gold TR USD	2.9	4.0	-4.3

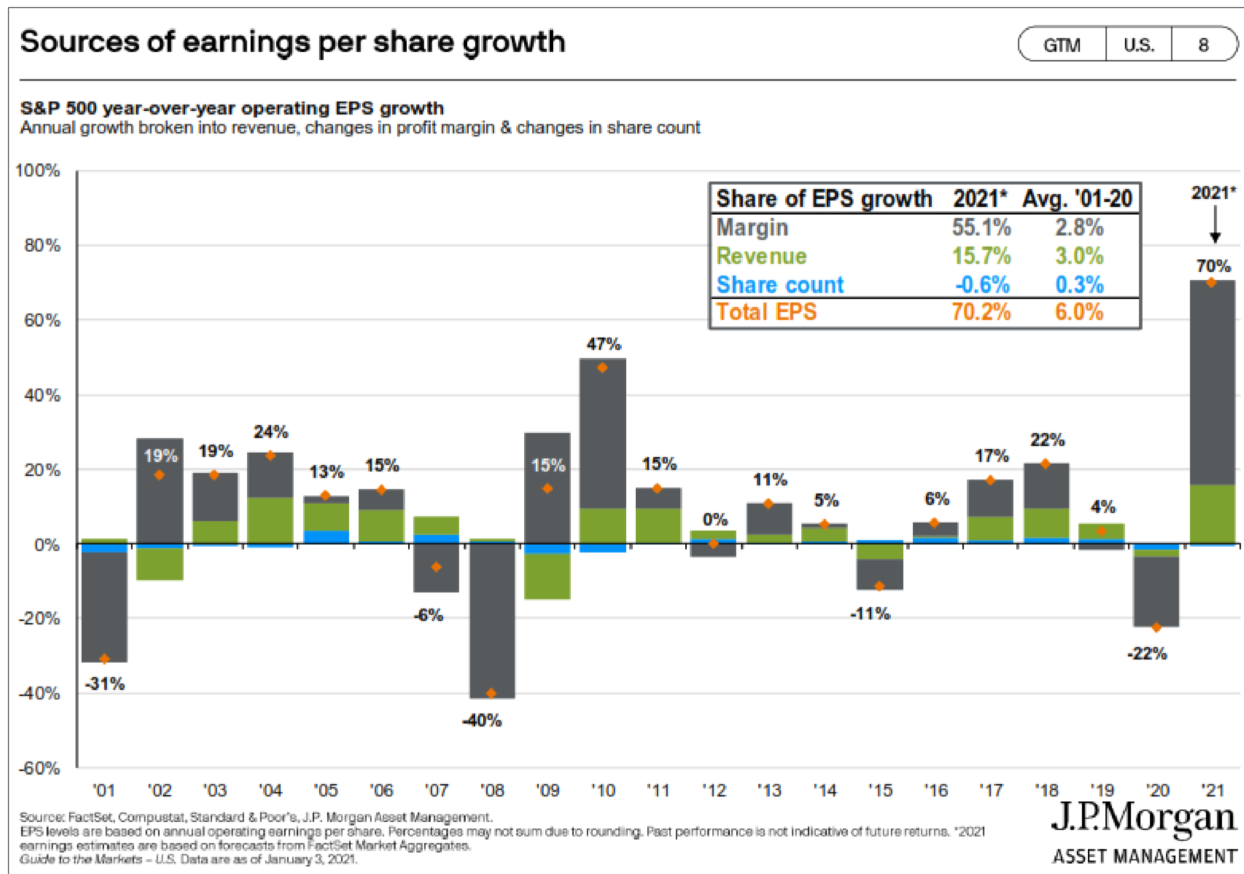
Source: Morningstar as of 12/31/2021

Inflation rose to the highest level in over 40 years catching complacent consumers and businesses off guard. The Federal Reserve finally conceded that inflation is anything but transitory and will pull out the 1980s era playbook to get inflation in check. Economic indicators suggest the economy is strong enough to withstand higher rates, but as always, the devil is the details as our capital markets have grown accustomed to low interest rates and excess liquidity. We will continue to closely watch equity valuations, the Federal Reserve's path in taming inflation, interest rates, the upcoming midterm election in the U.S., and of course the continued evolution of the pandemic.

[1] Morningstar Advisor Workstation as of 12/31/2021

U.S. EQUITIES – A LOOK UNDER THE HOOD

While market breadth declined towards the end of 2021, we are encouraged to see stock market returns driven by improving fundamentals versus multiple expansion. Revenue and earnings growth in 2021 were almost 5x and 12x larger, respectively, than the previous 20-year average. The consensus analyst estimate for earnings growth for the next two years is in the 10% range which remains above average. However, as of the date of this writing, so far in 2022, high flying small to mid-cap growth equities came back to earth. Many of the work from home pandemic stocks are firmly in bear market territory as investors recalibrated earnings and revenue assumptions going forward. While painful for these companies' stockholders, valuations approached 4x long-term averages in 2021 portending the good times could not continue indefinitely.[2]



At the expense of smaller companies, mega cap corporations increased market share since the pandemic began as they were able to accelerate technology spend and maintain high productivity in a hybrid office environment. The top 10 stocks in the S&P 500 now represent about 31% of the market capitalization and 26% of earnings contribution in the S&P 500 which is near the highest concentration in history. These companies (70% technology) were responsible for approximately 47% of the S&P 500 total return last year. As a result of large technology firms getting bigger, market capitalization weighted indices, like the S&P 500 and Russell 1000, have even more pronounced large cap and growth tilts. Value equities are trading around 17 times forward earnings and growth equities around 35 times. Since 1997, the forward price to earnings ratio of value to growth stocks averaged approximately 0.72. Today, this ratio stands at 0.48 indicating, on a relative basis, that value remains cheap while growth equities are expensive.[3]

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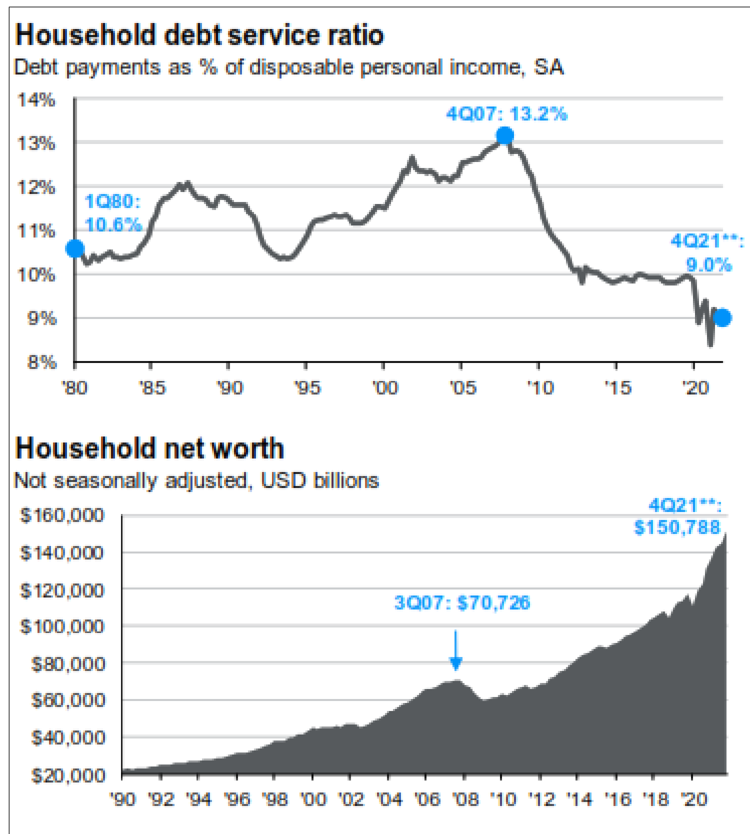
[2] JP Morgan Asset Management. Guide to the Markets. Data as of January 3, 2022. Accessed 1/6/2022.
[3] Ibid

U.S. CONSUMER WELL POSITIONED…BUT RESTLESS



Source: FactSet, FRB, J.P Morgan Asset Management, BEA. GTM Q1 2021:

Consumers remain quite strong financially. Debt payments as a percentage of disposable personal income continues to fall and is trending around multi decade lows. At the same time, Americans are wealthier than ever before. With ample job openings available, falling unemployment rates, and our propensity to consume, there is plenty of fuel for sustained consumer spending and continued GDP growth in the coming years. Counterintuitively, consumer sentiment continues to trend downwards. The University of Michigan Consumer Sentiment Surveys report a growing concern regarding rising inflation as well as continued uncertainty regarding the virus and political future of the U.S.[4] According to poll data aggregated by Real Clear Politics, the percentage of the U.S population responding they thought the country was headed in the right direction peaked around 43% in Q2 2021 and has been falling ever since.[5]

MAIN STREET HUMMING ALONG

The Conference Board Leading Economic Index continues to look good and may have accelerated to end 2021. Economic activity in the manufacturing and services sectors expanded at a decelerating pace in Q4 while demand continues to outpace supply. Businesses are reporting improving supply chain conditions and reduced logistical challenges, but high producer costs and shortages of labor and materials are forecasted to continue well into 2022.[6]

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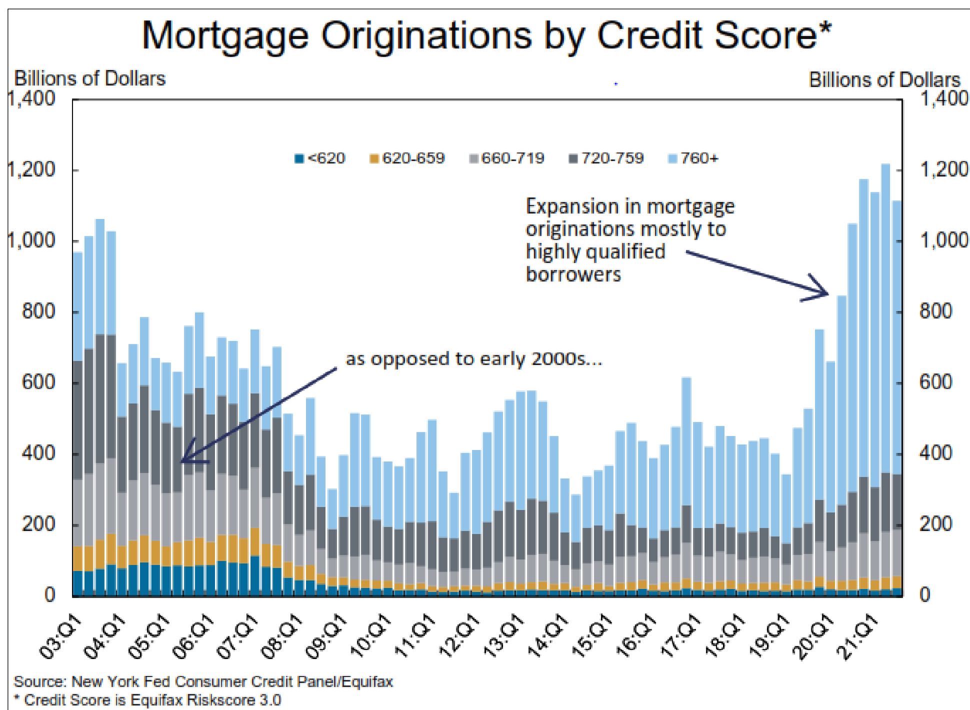
[4] Surveys of Consumers, University of Michigan, University of Michigan: Consumer Sentiment © [UMCSENT]. Surveys of Consumers (umich.edu). Accessed 1/5/2022.

[5] Real Clear Politics. https://www.realclearpolitics.com/epolls/other/direction_of_country-902.html. Accessed 1/6/2022

[6] ISM Report on Business. Institute for Supply Management. https://www.ismworld.org/supply-management-news-and-reports/reports/ism-report-on-business/pmi/december/. Accessed 1/5/2022

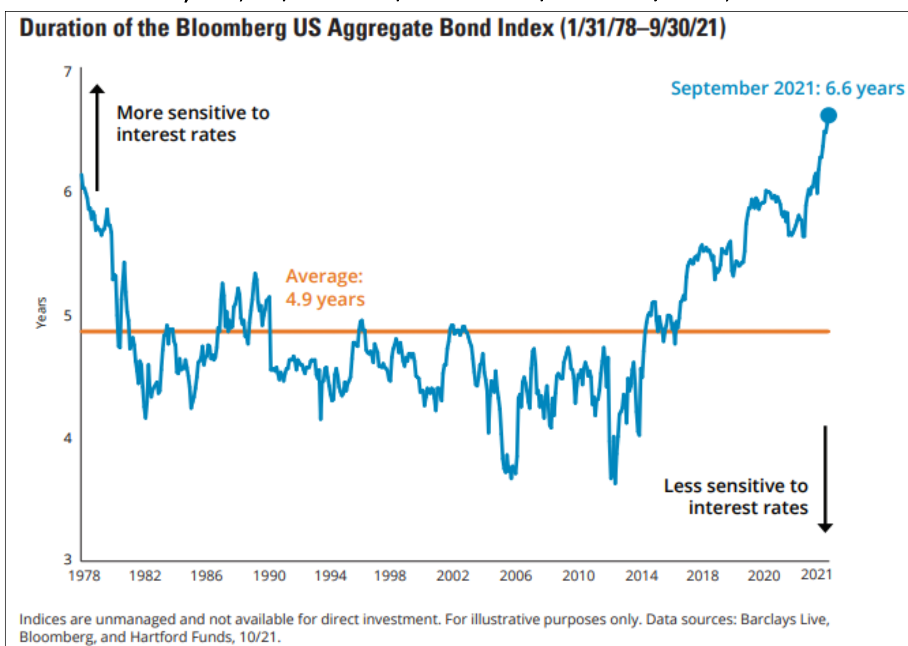


Residential real estate continued to appreciate at an above average rate with 12-month gains approaching 19% nationally.[7] Despite high prices, housing demand remains very strong, with low mortgage rates and inventory levels acting as tailwinds. Furthermore, an increasing percentage of new mortgage originations are going to highly qualified borrowers which bodes well for the health of the housing industry.

Unemployment is at post Covid-19 lows and should continue to trend downwards as the workforce returns to long term averages.

INTEREST RATES AND FIXED INCOME

Fixed income investments were challenged last year as rates rose in response to a recovering economy. Additionally, the Federal Reserve set expectations for rising interest rates to combat inflation. We know that bond prices move inversely to interest rate movements. Despite this relationship, negative fixed income returns during rising rate environments aren't guaranteed. Looking back at the last two rate hike cycles, 12/2015 – 8/2019 and 6/2004 – 6/2006, the Federal Funds Rate increased 2.25% and 4.25% while fixed income returned 3.91% and 2.75% annualized respectively.[8] Since 1974, there has not been back-to-back negative calendar year returns for the Bloomberg US Aggregate Bond Index.



Some market commentators argue that this time is different given that bond yields are so low, and the duration (a measure of interest rate risk) of the index is so high. As of September 2021, the duration of the Bloomberg U.S. Aggregate Bond was about 6.6 years. Meaning an immediate 1% increase in interest rates would result in an approximate 6.6% price decline of the index. Accordingly, passive fixed income investors have seen the duration of their

[7] S&P CoreLogic Case-Shiller U.S. National Home Price NSA Index. S&P Dow Jones Indices. S&P CoreLogic Case-Shiller U.S. National Home Price NSA Index | S&P Dow Jones Indices (spglobal.com). Accessed 1/5/2022.
[8] Morningstar as of 1/6/2022

fixed income portfolios increase over time. Our approach to mitigate this risk is to use actively managed fixed income strategies which can utilize a variety of methods such as reducing duration or buying higher coupon fixed income.

Some investors sought refuge in Treasury Inflation Protected Securities ("TIPS") last year, and they performed well. TIPS provide protection against inflation as the principal and semi-annual coupon adjusts with the Consumer Price Index. TIPS tend to do well when inflation rises and does especially well when the increase is unexpected. In deflationary environments, nominal treasuries will do better as the fixed rate coupons are not adjusted downwards. While TIPS do hedge against inflation risks, they are still subject to interest rate risk. On aggregate, many TIPS funds have much longer duration than comparable investment grade bond funds. For example, the largest TIPS ETF, the iShares TIPS Bond ETF (TIP) has an effective duration of 7.5 years versus approximately 6.8 years for the Bloomberg US Aggregate Bond Index.[9]

PATH DEPENDENT RECOVERY

Risks remain in our economy. Our supply chains and inventories continue to struggle to keep pace with historically high consumer demand. Overall, economists are forecasting that the rate of inflation will dissipate but that it is also likely to remain higher than average over the next two years. The rental price of housing and wages may continue to keep inflation persistently high as the former represents almost 30% of CPI. Many working adults have never felt inflation at these levels so we should expect the unexpected with regard to consumer behavior, especially if inflation persists longer than expected, generating a positive feedback loop.

Midterm congressional elections will take place this fall in the U.S., potentially shifting congressional control back to the Republicans. Last month, Senator Joe Manchin pulled his support for Biden's Build Back Better plan rendering it unpassable without major changes. We expect more of the same as the political showmanship continues up to the election. It is likely that President Biden will have to retool and focus on a smaller, more concise spending bill which may not be as aggressive on climate change and other clean economy initiatives. While stock market returns generally are not influenced by politics in the long-run, political news can impact sentiment, and stock prices, in the short run.

Data suggests the Omicron variant is considerably more transmissible and responsible for a sharp rise in breakthrough COVID cases. While the medical community remains strained, it is encouraging to see fatality rates not following suit. White House health officials have called for the Omicron peak to arrive as soon as the end of January, but time will tell. The recent spike in COVID-19 cases will take some time to be reflected in economic data. That said, despite positive cases being more than double the January 2021 peak, risk assets have performed well suggesting investors care more about interest rate expectations than virus related disruptions to our economy.

PORTFOLIO POSITIONING

We are positioning portfolios for continued, albeit slower, economic growth in 2022 than we saw in 2021. The combination of relatively high valuations, tightening monetary policy, and rising interest rates should put a ceiling on above average risk asset returns in the coming years. Value stocks look compelling as do foreign equities as valuations are attractive relative to the broader market. The illiquidity premium appears intact for many private assets over public assets including private credit and direct real estate. We anticipate bondholders will continue to face a challenging return environment for the foreseeable future.

[9] Ibid

A frequent question we receive from clients is, “Should I abandon my allocation to bonds if rates are going to keep going up?” The simple answer is no. Diversified portfolios are intended to preserve wealth. Bond performance may be uncomfortable for short periods of time during rising rate cycles, but higher coupon payments eventually offset unrealized losses on bond principal. Even in 2021 where bonds had a bad year, a conservative investor (50% stocks/50% bonds) outperformed their previous 15-year average by a wide margin.[10]

We continue to search for good risk adjusted opportunities across the investment landscape. We recommend staying disciplined with rebalancing, avoiding the temptation of chasing returns, and use new cash to dollar cost average into a diversified portfolio. Thank you for your continued trust.

Sincerely,
The Private Capital Management Team

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[10] Return assumptions based on an investment allocated 50% to AGG (iShares Aggregate Bond) and 50% to VOO (Vanguard S&P 500). Morningstar Advisor Workstation data as of 12/31/2021.

Investment products recommended by PCM:

Not FDIC Insured	No Bank Guarantee	May Lose Value
Not A Deposit	Not Insured By Any Federal Government Agency	