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Market Newsletter
December 31, 2021

EXECUTIVE SUMMARY

- US stocks and stocks of overseas developed markets rose in 2021 whereas high quality, interest rate sensitive bonds fell. Stocks of unprofitable technology companies fell sharply.

- The discovery of Omicron, the latest strain of the Covid-19 virus has dampened economic activity. This strain is highly contagious but less virulent than previous strains. The possibility of a highly infectious and virulent strain being discovered is a risk factor to the economy and the stock market. Otherwise, the economy will grow next year and should support stock prices.

- Inflation is the highest it has been in over 40 years. However, the components responsible for high inflation is expected to normalize in due course. Financial markets are projecting inflation to be a more manageable 3% or lower in the future.

- The Federal Reserve is expected to raise interest rates in 2022 and this could impact stocks. Fiscal policy is expected to support stocks.

- Corporate earnings grew by 70% in 2021 and were responsible for the strong performance of stocks. US stocks are expensive as compared to their historical valuation but are cheap in the light of historically low interest rates.

Table 1: Market indices

(Returns include dividends)	**Quarter to date**	**Year to date**	**1 Year**	**3 Year Annualized**	**5 Year Annualized**
S&P 500	11.03%	28.71%	28.71%	26.07%	18.47%
S&P Mid Cap 400	8.00%	24.76%	24.76%	21.49%	13.09%
S&P Small Cap 600	5.64%	26.82%	26.82%	20.11%	12.42%
MSCI Emerging Markets	-1.24%	-2.22%	-2.22%	11.33%	10.26%
MSCI EAFE	2.74%	11.78%	11.78%	14.08%	10.07%
Vanguard Total Bond Market Index (VBMFX)	-0.11%	-1.77%	-1.77%	4.71%	3.47%
Investment Grade Credit (C0A0)	0.17%	-0.95%	-0.95%	7.50%	5.28%
Non-Investment Grade Credit (H0A0)	0.66%	5.36%	5.36%	8.57%	6.10%
Bloomberg Commodity Index Total Return	-1.57%	27.11%	27.11%	9.86%	3.66%
Dollar Index (DXY)	1.53%	6.38%	6.38%	-0.17%	-1.31%
10 Yr Rate	1.51% 12/31/2021	0.92% 12/31/2020	0.92% 12/31/2020	2.69% 12/31/2018	2.45% 12/31/2016

Source: S&P Dow Jones, ml.com, MSCI.com, Morningstar, Bloomberg, Yahoo Finance

Table 2: Recent Major US Economic Releases (These indicators have a significant impact on the stock market)

As of 01/07/2022			
	Latest Release	Recent Trend	Notes
Non Farm Employment	199,000	Positive	The last two month's hiring was below expectations, but overall hiring was strong in 2021 with an average 537K monthly jobs number. There are 6.4 million more jobs available now than at the end of 2021.
Weekly Claims for Unemployment Insurance	207,000	Positive	Although the most recent number showed a spike because of Omicron, the recent trend is downward, reflecting an improving job market. The 4 week average of claims is 204,500.
ISM Manufacturing Index (over 50 indicates growth)	58.7	Positive	Manufacturing is demand driven but supply chain constrained. Shortages of critical materials, high commodity prices and difficulties in transporting products continue to plague consumption. The sentiment is positive and augurs well for 2022.
ISM Non Manufacturing Index (Over 50 indicates growth)	62	Positive	Although lower than recent highs, the non manufacturing sector is healthy and growing. New orders and inventories hurt the index.

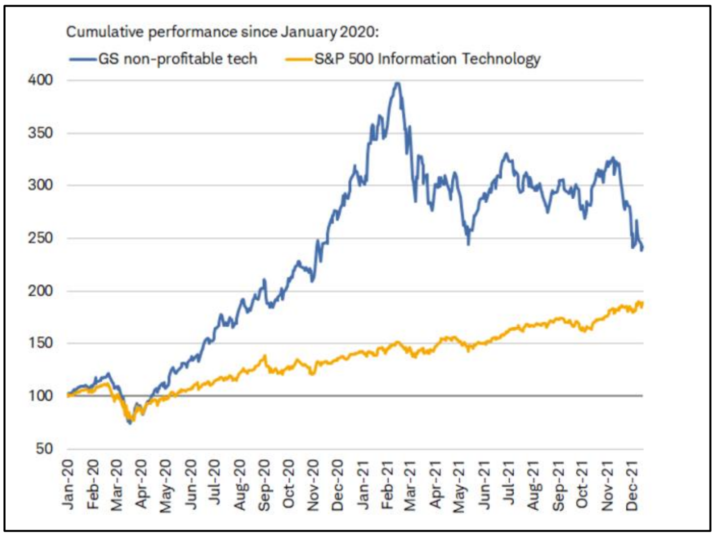
	Latest Release	Recent Trend	Notes
Consumer Prices (Month over month change)	0.8%	Negative	Since a year ago, headline inflation rose by 6.8% ,the fastest rate since 1982. Excluding food and energy, core inflation rose by 4.9% since last year, the fastest rate since 1991.
Producer Prices (Month over month change)	0.8%	Negative	Producer prices increased by 9.6% since last year. Excluding food and energy, producer prices have increased by 7.7%. Supply chain constraints is a big reason for the spike in inflation.
Retail Sales (Month over month change)	0.3%	Positive	Retail sales rose moderately in November before the holiday season. However, consumer spending is strong overall with a year over year increase of 18.2%. A subsequent report by Mastercard showed holiday sales were robust and increased 11% compared to 2019 before the pandemic hit.
Consumer Confidence (Conference Board)	115.8	Positive	Despite high inflation and increasing Covid-19 case counts, consumer confidence stayed strong in December.
Durable Goods Orders (Month over month change)	2.5%	Positive	Durable goods rose nicely in November helped by commercial aircraft. Core capital goods order, a proxy for business investment excluding aircrafts, fell 0.1% but has been on a positive trend recently.
Industrial Production (Month over month change)	0.5%	Positive	Despite supply chain constraints, industrial production increased 0.5% and factory output reached the highest level since January 2019.
Capacity Utilization	76.8%	Positive	Capacity utilization continues to edge up but is still below its long term average.
Housing Starts	1.679 Million	Positive	After a two month decline, Housing starts surged due to materials and labor shortages. Demand for homes continues to be strong. New home permits which is a harbinger of future starts also improved 3.6%.
Home Prices (Case-Shiller 20 city Index- Month over Month)	0.8%	Positive	Home prices are continuing to rise as buyers bid up prices. Year over year, the index was up 18.4%. Price improvement was not restricted to cities only, as the national index is up 19% since last year.
GDP (Real, Annualized)	2.3%	Positive	Third quarter 2021 GDP rose at a significantly lower level than the first two quarters (6.4%, 6.7%) hurt by covid 19 and supply chain issues. However, the trajectory of GDP growth is positive.

Source: Bloomberg, www.federalreserve.gov, www.bls.gov, www.ism.ws, www.nahb.org

In the fourth quarter of 2021, the investment themes witnessed earlier in the year continued for the most part. US stocks of all sizes rallied as did overseas stocks of developed countries. Emerging Market stocks continued to fall, impacted by the performance of Chinese stocks and stocks of countries battling Covid-19. High quality, interest rate sensitive bonds continued to fall in response to interest rate volatility (Prices of bonds are inversely related to interest rates) while low quality, credit sensitive bonds rallied. Commodities fell in the fourth quarter but had a strong year as supply chain constraints and inflation fears supported their prices.

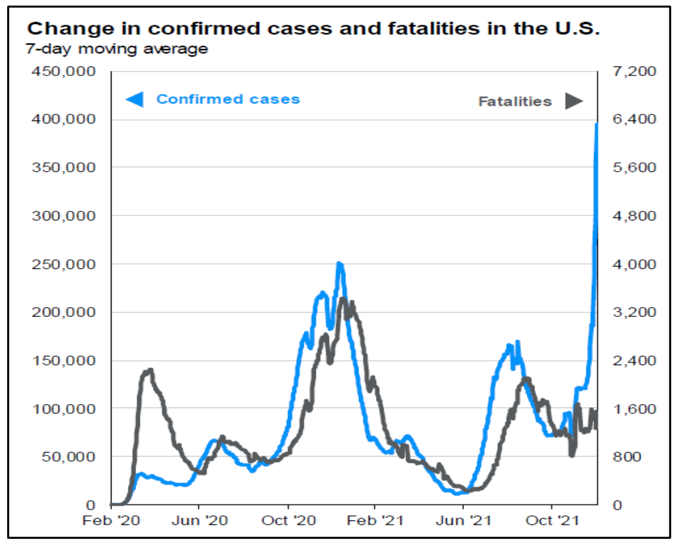
Despite a good year for stocks overall, under the surface, there was a remarkable diversity of returns, as stocks of unprofitable companies sold off sharply. For example, although the Russell 3000 (An index of stocks of the 3000 largest US companies) returned over 25% in 2021 and was at an all-time high, over 40% of the stocks in the index were 25% below their all-time highs. Unprofitable technology stocks were especially hurt- as seen in Figure 1. Stocks of large, profitable technology companies did better and contributed almost 20% to the market returns in 2021.

Fig 1: Unprofitable tech stocks have lost significant value.



Source: *Charles Schwab*

Fig 2: Covid fatalities have not kept up with infections

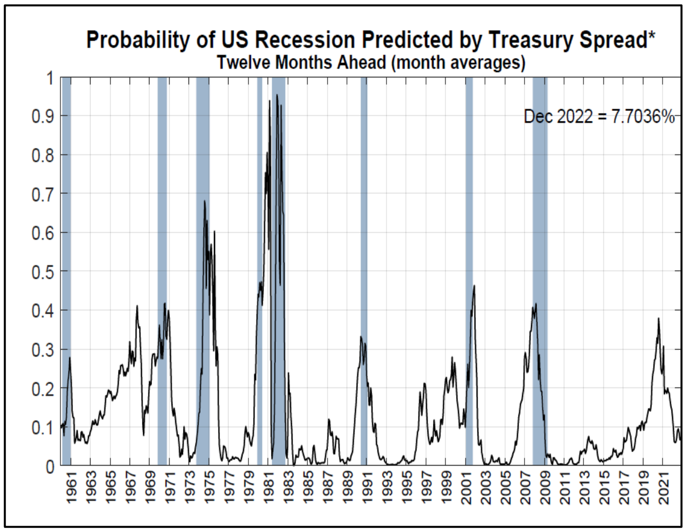


Source: JP Morgan

In the fourth quarter, the US economy and the markets were jolted by the discovery of Omicron, the latest variant of Covid-19. This variant is much more infectious than the earlier variants but is less severe based on number of hospitalizations and deaths. As seen in Figure 2, fatalities have not kept up with the rise in infections. The available vaccines have been doing a good job of protecting people from infections and/or from severe illness. However, infections and fatalities were higher in 2021 than in 2020 and were concentrated among the unvaccinated population. The possibility of a more contagious or virulent strain leading to extended lockdowns and supply chain disruptions remains a risk to the economy and the markets. As of now as seen in Table 2, the economy is recovering nicely from the depths of the Pandemic, although it has hit a speedbump recently because of Omicron. Barring some unforeseen conditions, the odds of a recession in the near term are very low. The New York Federal Reserve recession indicator indicates a less than 10% probability of a recession in the next one year. (Figure 3.)

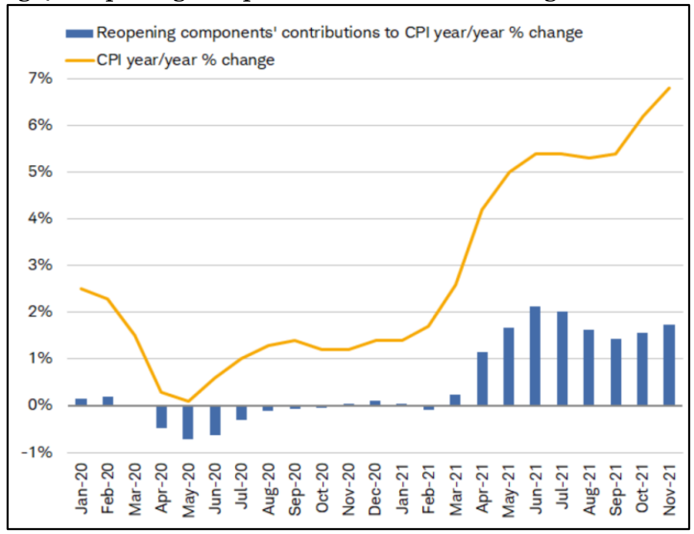
In 2021, inflation turned out to be much higher than expected. The Consumer Price Index (CPI) rose 6.8% between November 2020 and November 2021, the largest increase since 1982. The big debate in the market is whether this is transitory or long lasting. Looking under the surface, the components of the CPI that are associated with post covid reopening have played a bigger role in inflation as seen in Figure 4. These components such as used cars/trucks, rental vehicles, vehicle insurance, lodging, airfare and food away from home could normalize in due course. The other component that contributed heavily to inflation was energy prices, which was also impacted by the pandemic and is unlikely to have a material impact on inflation in the future. Market based indicators such as dollar inflation swaps (Which is the bond market's expectation of future inflation, as seen in Figure 5) and the University of Michigan inflation expectations next 5-10 years are signaling a lower and manageable inflation of around 3% or less in the future.

Fig 3: NY Federal Reserve probability of recession



Source: Federal Reserve of New York

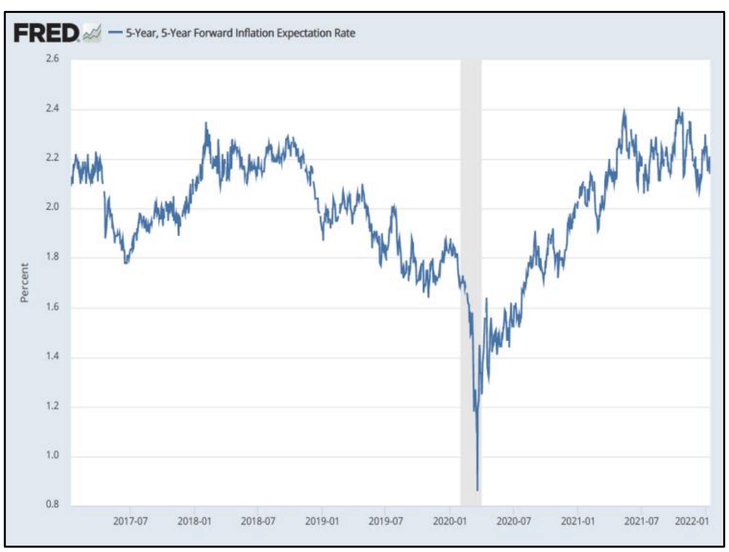
Fig 4 Reopening component of inflation are larger



Source: Charles Schwab

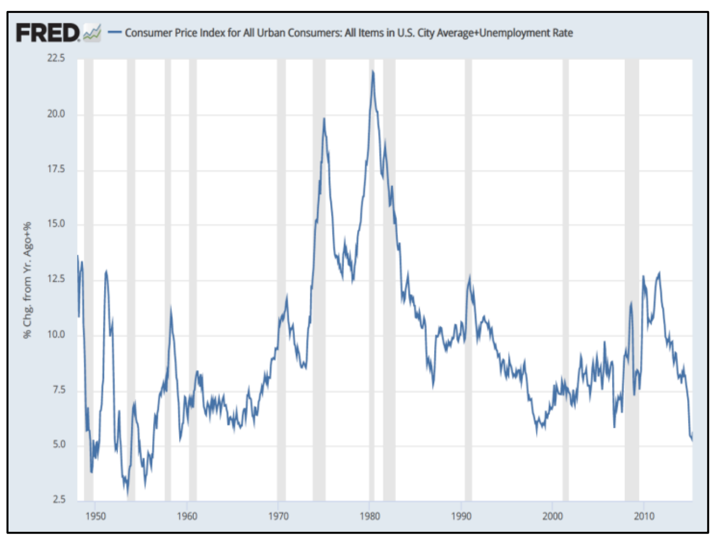
There has been a lot of discussion whether this spike in inflation along with slowing growth could end up in stagflation (Stagnation plus inflation a, problematic situation for the consumers and investors) like in the 70's. However, the unemployment rate currently is 3.9% which is quite low and the misery index (An index created by adding the inflation rate and the unemployment rate to measure the extent of stagflation) is much lower than it was in the 70's. See Figure 6.

Fig 5: The bond market expects lower inflation in the future



Source: Federal Reserve Bank of St. Louis

Fig 6: Historical chart of the 'Misery Index'

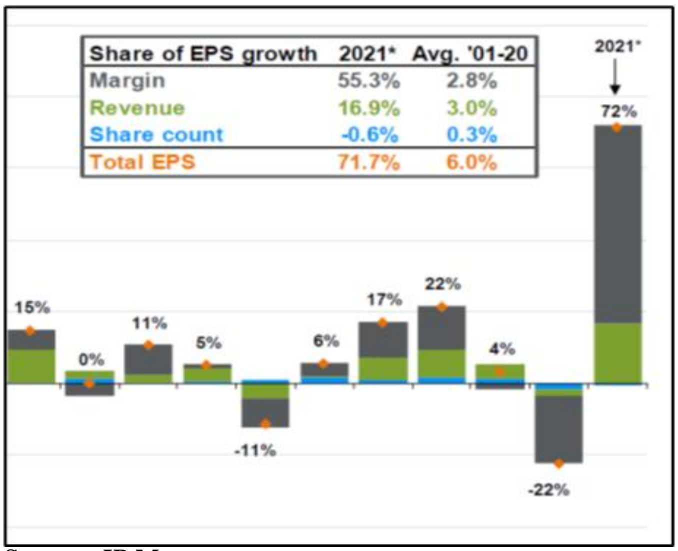


Source: Federal Reserve Bank of St. Louis

The US Federal Reserve (The Fed) has finally come around to acknowledging that inflation is more than just transitory. It had already been reducing its balance sheet (Which has the same effect as increasing interest rates) and now expects it will be lifting short-term interest rates “sooner or at a faster pace than participants had earlier anticipated.” The financial markets are expecting the Fed to hike interest rates as early as March 2022 and raise rates 3-4 times in 2022. This is significant for the stock markets, because interest rate hikes by the Fed is usually accompanied by high stock volatility. In 2018, the last time the Fed lifted interest rates, the equity market had two double digits drops including one of almost -20%. Investors can expect a high level of volatility in the stock markets in 2022.

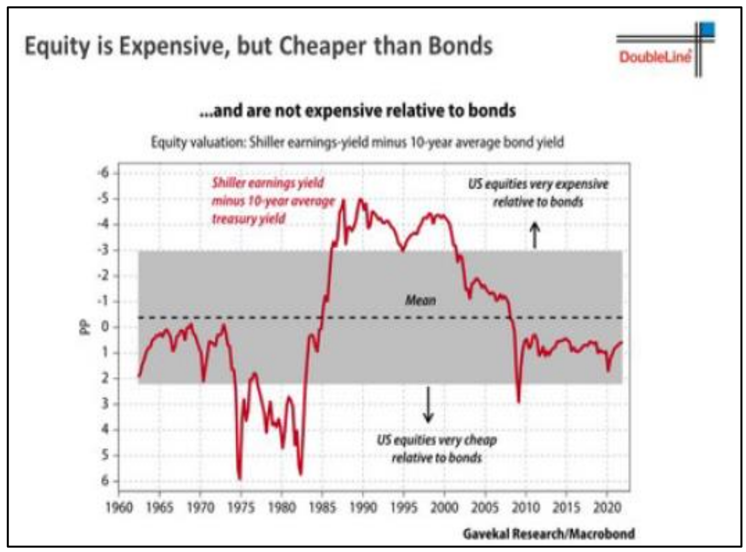
While monetary policy (Interest rates) is likely to be a headwind to stocks in 2022, fiscal policy will support economic growth and stock performance. The $1.2 trillion Infrastructure and Investments Jobs Act was signed into law in November and is expected to add as much as 0.5% to GDP growth. The larger Build Back Better plan could not be approved by Congress last year, but a scaled down version is likely to be passed this year. This bill will have a higher impact on economic growth.

Fig 7: Margin and sales growth contribution to earnings



Source: JP Morgan

Fig 8: Stocks are cheaper than bonds



Source: Doubleline, Gavekal research

Corporate earnings grew at a very healthy rate in 2021 helped by improving margins and sales growth. According to Factset, operating earnings are expected to grow by almost 22% in the fourth quarter of 202 1 the earning growth for the full year to 70%. Margin improvement contributed to the bulk of the earnings growth (Over 75%) and sales growth the rest of it (See Figure 7). Last year, stocks rose primarily because of earnings growth as multiples (The Price Earnings multiple, which is a measure of what price the market puts on corporate earnings) fell. Earnings expectations for 2022 are moderate but still positive and if price earnings multiple increase or at least stay the same, it could support higher stock prices.

Stocks are not cheap as compared to their historical valuation. The Price Earnings multiple of US stocks is currently 22 times, which is significantly higher than their 25-year average of 17 times. However, when you factor in historically low interest rates, stock valuations seem more justified. As seen in Figure 8, stocks are cheaper than bonds and that has historically supported further stock price appreciation.