Economic & Investment Outlook 2022

After the global pandemic and subsequent recovery of 2020, investors started 2021 with hopes of a return to "normal." Many factors provided for optimism, including a wide distribution of vaccines, easing of public lockdowns, and pent-up consumer demand. However, new challenges developed with the emergence of new COVID variants and supply chain shortages. Inflation rose to a level that has not been seen in decades.

Despite these challenges, most equity markets experienced a swift recovery and reached new market highs during 2021. This was caused by an addition of government stimulus, improving employment, and strong consumer demand. The chart below illustrates performance for various markets over a 10-year period.

Index	4th Qtr.	2021	3 year*	5 year*	10 year*	Description
S&P 500 Index	11.03%	28.71%	26.07%	18.47%	16.55%	Large-Cap Stocks
Russell 1000 Growth	11.64%	27.60%	34.08%	25.32%	19.79%	Large-Cap Growth Stocks
Russell 1000 Value	7.77%	25.16%	17.64%	11.16%	12.97%	Large-Cap Value Stocks
Russell 2000 Growth	0.01%	2.83%	21.17%	14.53%	14.14%	Small-Cap Growth Stocks
Russell 2000 Value	4.36%	28.27%	17.99%	9.07%	12.03%	Small-Cap Value Stocks
MSCI – EAFE	2.74%	11.78%	14.08%	10.07%	8.53%	International Stocks
MSCI – Emerging Market	-1.24%	-2.22%	11.32%	10.26%	5.87%	Emerging Market Stocks
Barclay's Agg. Bond Index	0.01%	-1.54%	4.79%	3.57%	2.90%	Domestic Bonds
Consumer Price Index	1.64%	7.04%	3.53%	2.92%	2.14%	Inflation
*Returns are annualized						

<u>The Year in Review</u>

At the start of 2021, the economy appeared to make progress. COVID cases started to decline and businesses began to re-open. We observed the strong performance of "value" stocks, which include energy and financial companies. These began to outpace the returns of "growth" stocks, which are comprised mostly of technology and health care companies.

However, later in the year, the Delta variant brought back concerns of a second round of a pandemic slowdown. As health concerns rose, the stocks of health care and technology companies began to outperform. Consumers stayed home, were forced to quarantine, and used the Internet to meet their needs for work and shopping. From that point on, we saw large-cap growth stocks exceed the return for value, returning +11.64% and +7.77%, respectively. This is illustrated by the 4th quarter returns of the Russell 1000 indices above. Ultimately, for 2021, the performance for both of these broad-market indices produced similar results.

For small-cap investors, it was a tale of two very different scenarios. As shown by the Russell 2000 Indices for 2021, small-cap value rose +28.27%, while small growth only rose +2.83% for this period. Disparities such as these are sometimes difficult to explain, but it was probably a result of many small-cap growth companies not being able to handle the supply chain challenges. Larger companies possess more resources to do this.

Overseas we saw international developed stocks rise alongside US stocks, posting low double digit returns for the year. While their emerging market counterparts were flat during the first half of the year, they subsequently slid to single digit losses for the full calendar year. The governments of these emerging economies have less firepower to combat the economic hardships of the global pandemic and the runway of their recovery will be longer than we have seen in more developed economies.

Fixed income markets experienced meager returns in 2021, due to the pressure of rising interest rates. Additional headwinds occurred as the Federal Reserve Bank began a policy of "quantitative easing". They accomplished this by reducing their purchases of bonds in the open market. The resulting rise in interest rates caused the value of existing, lower-yielding bonds to decline in value. While these events often produce volatility and negative investment returns in the short-term, the higher yields eventually begin to benefit investors with a long-term outlook.

Challenges we face in the coming year

Inflation spiked to an annualized rate of 7.04% for the calendar year of 2021. While this is a historically high rate, the origin of this inflation is caused mainly by tremendous consumer spending, high demand for employment, and government policies designed to stimulate the economy. Inflation may continue at higher-than-average levels as supply shortages take time to catch up. This could put downward pressure on corporate profits as input costs and labor costs increase.

Interest rates are currently at relatively low levels. However, if they rise too high too fast, this could provide a headwind for overall economic growth. The Fed must balance inflation and interest rates with the goal of allowing the economy to grow, but any mis-steps could also trigger an economic recession. Currently the Fed is scheduled to end their bond buying program by May 2022. Recent comments from Fed Chairman Mr. Powell, however, indicate this could end sooner.

Government response to the pandemic in 2020 and 2021 helped to offset the impact of various business shut-downs. This enabled the economy and the investment markets to grow. However, fiscal economic support from the government appears to be slowing as indicated by the state of gridlock in the House and Senate. Fewer legislative bills have been passed over the course of the last year than have been in over a decade. Government officials will need to navigate the potential trade-off of higher spending with a more balanced budget. Future discussions about debt ceiling challenges and risks of government shutdown will likely fuel market volatility.

Finally, the variants of COVID-19 could pose further economic risks as our medical professionals continue to learn how to prevent, protect, and treat these variants. As a society, we have varying levels of tolerance for the "new normal". This will result in more heated debate from both mainstream media and social media channels, which might trigger short-term market volatility.

Reasons for Optimism

Many of the foundations for growth we saw in 2021 will continue in 2022. Consumer spending makes up roughly 70% of our economic growth. With consumer demand continuing to be strong, company earnings have been exceptionally high, quite often outperforming analysts' expectations. Retail sales and housing starts have also been exceptionally strong. Meanwhile, although new auto sales have been very low due to global supply chain shortage of computer chips, manufacturing will probably start to catch up in 2022. This will help to spur an increase in auto sales again.

Corporate earnings are the single biggest factor of stock price growth over long periods of time. Strong earnings will likely lead to strong market returns. Corporate profit margins are still at record highs, and this may continue into 2022 as consumer demand increases and supply-chain issues begin to fade. Also, the combination of low interest rates and government stimulus packages have set the stage for continued economic growth by providing corporations access to cheap capital. These factors allow them to grow their business as desired.

A healthy job market also provides opportunities for economic growth. Together, strong corporate profits and consumer demand help to maintain a healthy labor market. Currently there are more job openings than there are individuals looking for jobs, and the most recent unemployment reading was 3.9%. This is a number economists consider to represent "full employment" and similar to what was last seen in 2017.

Finally, although current valuations as measured by stock price to earnings per share (P/E ratio) are above average for some companies, it appears that valuations are not as high in small and medium-sized firms in both the US, and many international markets. We continue to be optimistic that these areas could provide excess return in 2022.

Conclusion

Our Outlook for 2022 is cautiously optimistic. This year, like most, is likely to experience periods of uncertainty and volatility. In fact, the average intra-year decline of the S&P 500 since 1980 has been 14%. However, over the same time period, the Index has posted a positive annual return in 32 of those 42 years. Volatility in equity markets is unavoidable for investors seeking to maximize their long-term returns. The approach that we implement for our client portfolios allows us to use this volatility to our advantage through diverse asset allocation and disciplined rebalancing.

Prudent Portfolio Management Integrated with Comprehensive Financial Planning Provides the Best Long-Term Results

As described in previous communications from Total Wealth Planning, we advocate a proven Nobel Prize-Winning Approach for managing our client's investment portfolios. By maintaining consistent exposure to a diversified array of 15-20 individual asset classes, clients' investment portfolios will have every opportunity for growth. By making tactical shifts, over and above periodic rebalancing and profit-taking opportunities, we seek to add value, especially during periods of elevated volatility. At Total Wealth Planning, our team of financial planning and investment management professionals work closely together to ensure that opportunities for adding value to your financial situation are not overlooked. In our opinion, wealth-building and preservation must include not only investment management, but also financial planning activities. These include cash management, debt management, tax planning, risk management, college funding, retirement planning, and estate preservation.

We appreciate the trust and confidence clients have placed in us for the past 30+ years, and we look forward to seeing you in 2022!

Total Wealth Planning Investment Policy Committee:

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