



Investment Review and Outlook

January 2022

The fourth quarter capped a remarkable year in terms of equity market performance. Moreover, this strong performance came in the face of a continued highly uncertain economic backdrop. While the market experienced a somewhat sharp bout of selling once again in late November, due to the rapid spread of the new Covid-19 variant (Omicron), the stock market rebounded solidly in December. More encouraging was that the stock market registered broad gains across many industries and individual stocks.

Many long-term investors continue to worry about seemingly elevated equity valuations. But when taking a step back, one will notice that the market ended the year at valuation metrics similar to the end of 2020. The S&P 500 generated total returns of 28.7%. But corporate profits surged at an even faster pace, led by substantial profit growth from many companies and sectors that were negatively impacted by the Covid-19 economic shutdown.

So, what could possibly go wrong? Clearly there are always unforeseen events that could adversely impact the markets and the economy. For example, while we were predicting higher inflation in 2021, we, and nearly all economic prognosticators, did not anticipate inflation surging to the current mid-to-high single digits. The Federal reserve has finally conceded its position that inflation was a transitory problem. The Fed has telegraphed its intention to end quantitative easing shortly and will likely raise interest rates this year. Rising rates and higher inflation are normally formidable headwinds for the equity markets.

But the pace of the tightening will be the critical issue for the markets in our judgment. If the Federal Reserve raises the Fed Funds rate to 1% by the end of 2022, we do not believe this would alarm investors. The market could have a year of reasonably good returns, albeit more modest than 2021. But if inflation proves to be more nettlesome, and the Fed's hand is forced to strike more forcefully, perhaps the market performance will be more challenged.

60/40 Hindsight

Earlier this year we penned an article for the Jewish Link questioning whether bonds can continue to serve as a robust shock absorber for equity portfolios, which could help generate optimal risk adjusted returns. Historically, bonds have been a reasonably good diversifier because their returns have been generally negatively correlated to equity returns. More recently that relationship has been evolving.

There are other macroeconomic challenges for the bond market. Yields across the spectrum of fixed income assets are historically very low. Moreover, yields have been predominately running well below the level of inflation. Thus, we see increasing risk that bonds may not be able to perform well in the near term, even if the stock market experiences a correction.

We believe that bonds still have a place in a balanced portfolio. Selectivity will likely be more important than in the past. For example, in 2021 inflation-protected bonds performed significantly better than their plain vanilla traditional fixed income brethren.

Finally, it is important to understand that bonds can have significant inherent risk of principal losses. Just as an example, the iShares 20+ Year Treasury Bond ETF (TLT) fell over 2.5% on the first trading day of the year. That one-day loss in principle was greater than the annual interest yield on that ETF (approximately 1.50%). Investor beware!

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