AndCo's Monthly Market Update

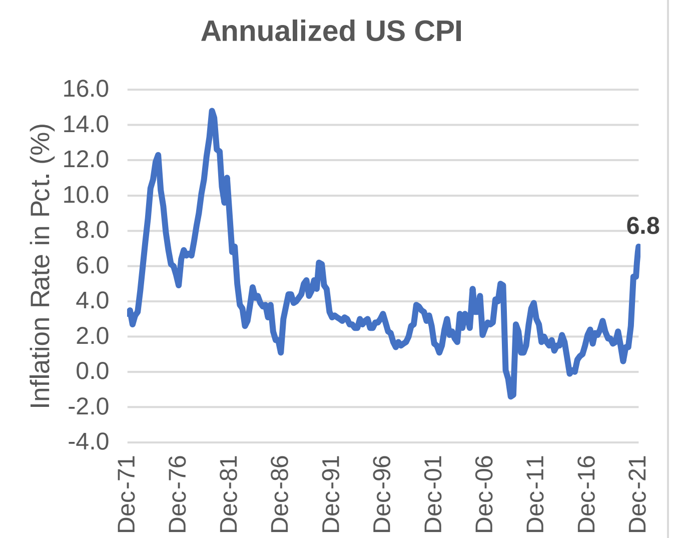
January 2022

THE ECONOMY

"Your present circumstances don't determine where you can go. They merely determine where you start" – Nido Quebein

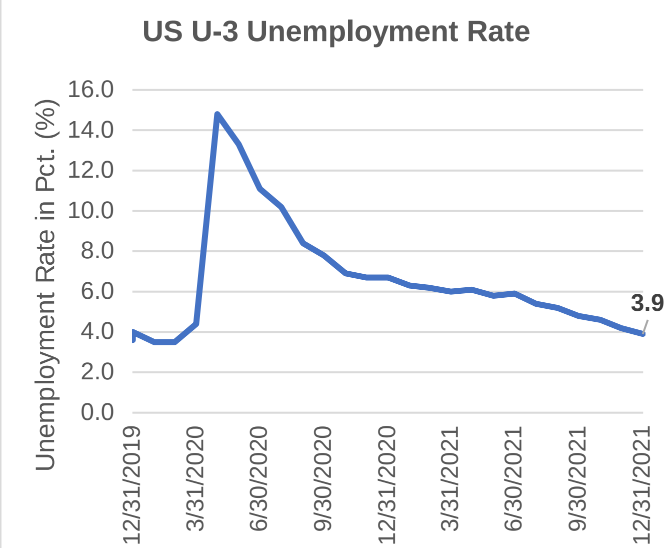
While challenging for a myriad of reasons, 2021 was a good year from both an economic and overall financial market perspective. Despite concerns about rising inflation, supply chain disruptions, and the uncertainty related to the pandemic resulting from the Omicron variant, the economy continued to recover. Fortunately, while there is a significant rise in new cases, the new strain appears to be less severe, which, when combined with improved medical treatments, should lessen the potential negative impacts to the economy.

The most noteworthy economic story of the year was undoubtably the rapid rise in US inflation and the resulting pivot by the Federal Reserve Bank (the Fed). Prices of goods and services increased rapidly during the second half of the year with the December US CPI posting a rate of 7.0% annualized.[1] The resulting headline CPI reading is the fastest acceleration of inflation in more than four decades.[2] The Fed had been positioned to allow inflation to run faster than the historical 2.0% target to allow the economy to heal from the pandemic. Importantly, the narrative was that the spike in inflation was "transitory" and should moderate as the pandemic waned and supply chains normalized. Unfortunately for consumers, neither of those two events has occurred yet. As a result, the Fed made the decision to accelerate the tapering of its bond purchase program, which is now expected to end sometime in the first quarter of 2022. Equally as important, the release of the Fed's meeting minutes in December spelled out the potential for the beginning of a new rate rising cycle has been pulled



Source: Bloomberg as of January 12th, 2022 forward.[3] Given the recovery we have witnessed in the economy, we believe the shift in monetary policy is reasonable, and the Fed may be a little "behind the curve" with its shift in viewpoint.

Since the onset and subsequent economic drawdown resulting from the pandemic, we postulate the Fed has been focused on one of its dual mandates (employment) at the expense of the other (price stability). As illustrated in the chart below, the unemployment rate has steadily declined since the peak in April of 2020 and registered a rate of 3.9% in December.[4] What is interesting about this statistic is that it does not tell the whole story about the labor market. The number of eligible Americans working remains mired at a near 40-year low.[5] One explanation for the low number of workers has been labeled the "Great Resignation", where workers simply walk away from their employment.[6] In thinking through this phenomenon, there are a likely variety of contributing factors including vaccine restrictions, lack of adequate childcare, and continued support from government programs. Regardless the reason(s), the number of people resigning from their jobs hit an all-time high in November.[7] While the Fed will likely remain focused on achieving full employment in the near-term, in the long-term, continued economic growth could be hampered as business struggle to both attract and retain quality employees.



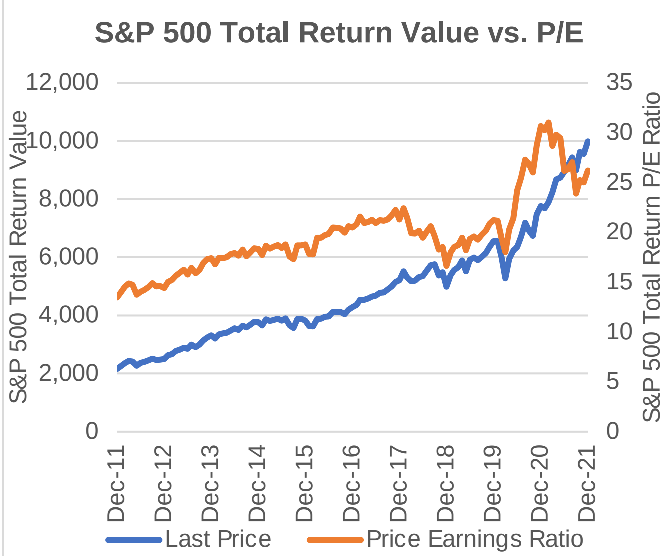
Source: Bloomberg as of January 7th, 2022

Considering the potential impact of labor market challenges, there are several key implications to deliberate. First, clearing backlogs in the supply chain may prove difficult given the lack of qualified employees needed to do these jobs and relieve the stress. Second, should the number of employees resigning from their jobs remain above the long-term trend, such a condition would put pressure on employers to increase compensation and benefits to attract and retain their workforce. This belief is visible in the forecast by the Conference Board's Salary Increase survey which indicates that employees can expect compensation to increase by 3.9% during 2022, the fastest increase since 2008.[8] Despite these expectations, overall wage growth has not kept up with the recent spike in inflation, meaning workers continue to fall behind as prices rise. Importantly, employers are also feeling pressure as other business costs have risen, which reduces profit margins outside of wage growth. While most business will seek to pass along cost increases to consumers, rising prices for goods and services has the potential to create a negative feedback loop, which will further stoke concerns about rising inflation.

Finally, as long-term investors, it is always challenging to remain focused beyond the horizon when so much is happening in front of us. We also recognize that the ability to forecast markets accurately for any time horizon is losing proposition. However, looking forward into 2022, we believe it is reasonable to expect the Fed to remain true to its word and begin the process of normalizing interest rates with the goal of combating rising inflation. This may come in the form of one, two, or three rate hikes during the year. The speed and the magnitude of the change will likely depend on the ability of the economy to stand on its own two feet. Outside of a geopolitical conflict or supply shock, energy prices will likely increase at the pace of economic growth. Given the likely outcome of a slowing pace of energy price increases, the impact on future inflation should be reduced. Barring an economic slowdown, the labor market should remain strong as demand outstrips supply, which should result in higher wages. For these reasons, we believe there is cause to be optimistic as we begin the New Year, albeit with a trained eye that recognizes the only constant is change.

EQUITIES

Despite concerns about the rapid increase in COVID-related infections, rising inflation, and the potential for a change in monetary policy by the Fed, global equity markets were broadly higher across market capitalizations and styles in December.[9] For the month, the S&P 500 Total Return Index rose by 4.5% while the small cap Russell 2000 Index increased by 2.2%.[10] For the full year, the S&P 500 Index returned 28.7% while the Russell 2000 Index returned 14.8%.[11] Strong fundamental growth, combined with continued easy monetary policy, likely drove returns during the year. From a valuation perspective as measured by the P/E ratio, equities remain above their long-term historical average, registering at 26.2 as of December 31st, 2021.[12] However, relative to their lofty levels earlier in 2021, recent growth in earnings has mitigated some of the concerns about equities being over-valued.

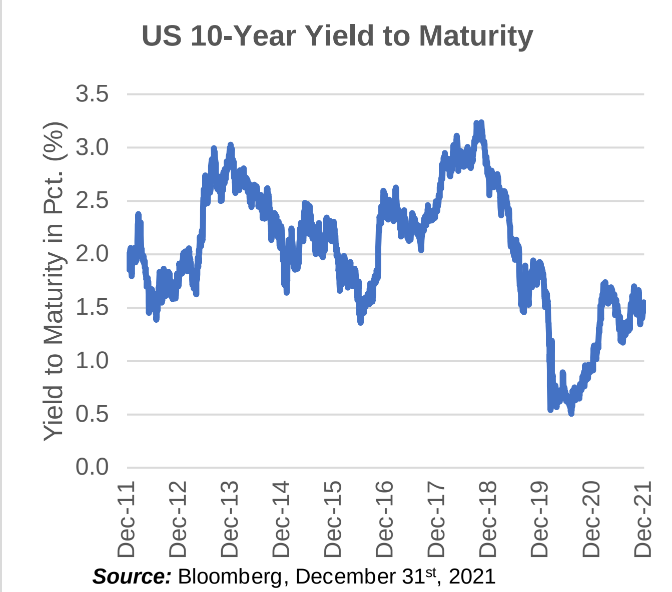


Source: Bloomberg as of December 31st, 2021

Overseas, international developed and emerging equity markets saw positive gains during the month of December with the MSCI EAFE Index rising 5.1% and the MSCI Emerging Markets Index gaining 1.9%.[13] Returns for the full year were mixed with the MSCI EAFE Index climbing 11.3% while the MSCI Emerging Markets Index declined by -2.5%.[14] The primary component of the disappointing emerging market returns was China. The CSI 300 Index declined -3.5% during the year as investors focused on concerns related to slowing economic growth and the headline grabbing Evergrande default.[15] Similar to the US, overseas markets faced headwinds related to rising infections and regional restrictions which hampered economic growth. Additionally, during the second half of the year, Europe and the UK were faced with sharply higher energy prices that negatively affected growth. Finally, the strengthening US dollar (USD) has been a headwind for foreign equities with the USD rising against both the Euro and yen currencies during the year.[16] With the Fed poised to begin raising interest rates, and the European Central Bank and Bank of Japan indicating they will maintain their current accommodative policies, it is likely the USD will continue to act as a headwind to foreign investment returns as US interest rates rise.

FIXED INCOME

Fixed income returns were generally challenged for the month and for the full year with the lone exception being US High Yield bonds. The key driver of return during the past year was the steady rise in US inflation, which remains well above the Fed's stated target average of roughly 2.0%. To combat this inflation trend, the Fed began tapering its bond purchases to reduce market liquidity and hinted it would begin raising interest rates earlier than the market had expected. As a result of these changes in Fed policies, the benchmark US 10-Year Treasury Bond yield rose roughly 60 basis points from a yield of 0.9% to 1.5% during the year.[17] While longer-dated government bonds performed poorly, investors' appetites for higher yielding assets remain robust. For the full-year, high yield bonds returned 5.3%, significantly outperforming higher quality bonds represented by the Bloomberg US Aggregate Bond index which returned -1.5%.[18] High yield bonds benefited primarily from their shorter duration profile (generally larger coupon and shorter maturity) which mitigated a portion of the risk associated with rising interest rates. Importantly, high yield bonds have performed well historically during periods of rising interest rates. Since 1994, as interest rates have risen, high yield bonds have experienced positive returns during all 13 periods.[19] While the past is not necessarily a prologue, given the trajectory of the economy and US interest rates, it is reasonable to expect that lower quality bonds and bank loans should continue to outperform higher quality bonds.



Source: Bloomberg, December 31st, 2021

	Index Returns			
Index	December	4Q 2021	2021	Duration (Years)
US 1-3 Gov/Credit Index	-0.15%	-0.56%	-0.47%	1.92
US Intermediate Gov/Credit Index	-0.13%	-0.57%	-1.44%	4.13
US Aggregate Bond Index	-0.26%	0.03%	-1.54%	6.78
US Corporate Investment Grade Index	-0.08%	0.23%	-1.04%	8.70
US High Yield Corporate Index	1.87%	0.66%	5.28%	3.83
Global Aggregate Bond Index	-0.14%	-0.70%	-4.71%	7.38

Source: Morningstar, Baird Global Advisors, December 31st, 2021

APPENDIX

1. Bloomberg, January 12th, 2022
2. Bloomberg, January 12th, 2022
3. https://www.usnews.com/news/economy/articles/2022-01-05/feds-december-meeting-minutes-found-economy-much-stronger-with-higher-inflation
4. Bloomberg, January 7th, 2022
5. Bloomberg, December 31st, 2021
6. https://www.thestreet.com/investing/resignations-hit-peak-in-november-2021
7. https://www.usatoday.com/story/money/2022/01/04/great-resignation-number-people-quitting-jobs-hit-record/9083256002/
8. https://www.conference-board.org/research/economy-strategy-finance-charts/Salary-Budget-Increases-2021#:~:text=The%20Conference%20Board's%20Salary%20Increase,the%20highest%20rate%20since%202008.
9. Morningstar, December 2021
10. Morningstar, December 2021
11. Morningstar, December 2021
12. Bloomberg, December 31st, 2021
13. Morningstar, December 2021
14. Morningstar, December 2021
15. Bloomberg, December 31st, 2021
16. Bloomberg, December 31st, 2021
17. Bloomberg, December 31st, 2021
18. Morningstar, December 2021
19. https://www.alliancebernstein.com/corporate/en/insights/investment-insights/why-high-yield-investors-are-rooting-for-rates-to-rise.html

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