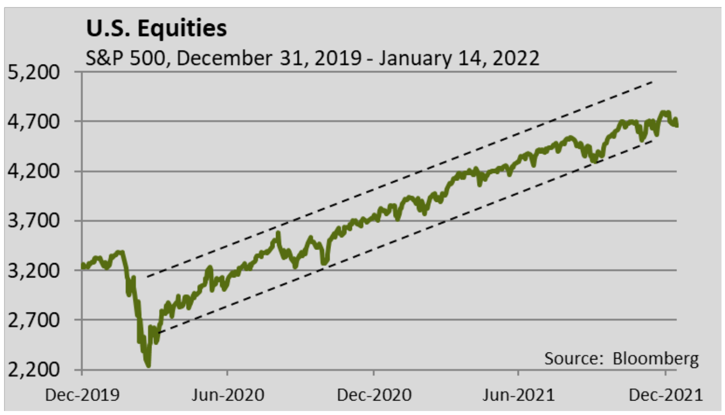
A Transition Year

January 2022

Summary

While the world remained tense over the ongoing pandemic, the stock market did not skip a beat in 2021. Fueled by massive monetary and fiscal stimulus, unemployment and economic growth furthered the recovery that started in 2020. The U.S. stock market was not only strong but extremely steady as well. The S&P 500 generated a 29% return, and the biggest drawdown throughout the year was 5.2%. Consequently, 2021 saw the second lowest calendar year volatility in the last 25 years. In contrast, rising interest rates generated negative returns from investment grade bonds. The -1.5% loss was the third worst performance for bonds since 1980. Only 2013 and 1994 were worse.



2022 is Likely to be a Year of Transition

Since the onset of the pandemic, actions from the Federal Reserve and Congress were focused clearly on reducing its risk and impact on the economy. With the recovery well underway, Fed policy, congressional stimulus, inflation, and GDP are likely to undergo significant changes. Even COVID-19 circumstances may be changing. Sometimes transitions can be uncomfortable. Stock market returns will likely be significantly lower in 2022, and the extreme stability of 2021 seems untenable. However, the potential for lower returns and higher volatility does not mean the stock market is on the verge of collapse.

- **It has been almost two years since the start of a 10% correction**, well beyond the average period of eight months. Last year was an abnormally calm year for financial markets; it will be difficult for 2022 to replicate such a combination of high returns and low volatility.
- **The market cycle seems to have accelerated**, and fast-paced changes may continue as it enters the later phases of the cycle.
- **The Fed is likely to raise interest rates meaningfully in 2022.** For the first time since the onset of the pandemic, the Fed will end its policy of extremely easy monetary policy. BCA Research summarizes, “Even if the [Fed] were to raise rates three times in 2022, as the market is currently discounting, the fed funds rate would still be half of what it was on the eve of the pandemic.”
- **The mid-term election year is the weakest year in the four-year cycle.** Since 1948, the S&P 500 was positive only 61% of the time, and the median gain per year was only 6.2%, significantly less than the other three years.

A Transition Year on Many Fronts

Financial markets performed well in 2020 and 2021 due, in part, to the extraordinary amount of stimulus provided by the government to cushion the blow from the pandemic on the economy. Since March 2020, the Federal Reserve and Congress kept the "pedal to the metal" on both monetary and fiscal policy. In 2022, many components of the economy will be in a period of transition:

- **Fed rates:** The Fed is likely to raise rates for the first time since the onset of the pandemic. The Fed Funds Rate was pinned at effectively zero for the past 22 months.
- **Fed asset purchases:** The Fed is planning to end its bond buying program by March 2022.
- **Congressional stimulus:** The monetary stimulus from Congress (additional unemployment benefits, direct payments, etc.) was a significant source of liquidity for financial markets in 2020 and 2021. Most of those programs ended in the fall of 2021.
- **Inflation:** Following years of low inflation, CPI jumped at the end of 2021. It is likely that the 7% December 2021 reading will moderate in 2022 as the supply chain and other factors diminish.
- **GDP:** Real GDP is expected to normalize. After plummeting in Q2'20 by 31%, Real GDP rebounded quickly by 38% in Q3'21. In Q1'21 and Q2'21, GDP continued to grow quickly at 6.3% and 6.7%, respectively. Q3'21 returned to a more normal 2.3%, and a more modest pace is expected to continue in 2022. For context, the average quarterly Real GDP (adjusted for inflation) growth rate from 2010-2019 was 2.2%.
- **Covid:** While this aspect seems to be in constant transition, at the beginning of 2021, vaccines had just been approved and effectively no one had been vaccinated. At the beginning of 2022, over 75% of the U.S. population (and 60% of the world population) has had at least one dose of the vaccine. [Source: ourworldindata.org]

Expecting Speed & Volatility

The changes in this economic cycle have been fast paced. Both the economy and financial markets saw significant swings in many directions. At the onset of the pandemic in 2020, stocks realized the fastest bear market in history. Months later, the shortest recession in history was over, and stocks recovered to new highs faster than ever before. Inflation readings were at 1.4% in early 2021, and then spiked to 7.0% by December. Hold on to your seats.

At the same, there has been volatility in the stock market that has not been apparent in the stock market averages. For instance, many stocks have been declining during the last few months while the broader averages have been rising. The dynamics of the NASDAQ Composite, a broad-based index that represents over 2,500 companies, demonstrate the underlying volatility. Over 64% of the NASDAQ stocks were down by at least 20% in the last four months (as of mid-January). Over the last month, while the S&P 500 was roughly flat, large growth stocks fell by -5% while large value stocks advanced by 3%.

While there is no timer set for when volatility will strike more deeply, it has been 451 trading days (almost two years) since the start of a 10% correction. Since the initial pandemic drawdown of -34%, the broad market indices have been very stable. In 2021, the maximum drawdown in U.S. stocks was 5.2%. Since, on average, the stock market falls by 10% every 171 trading days (roughly every 8 months), higher volatility is not uncommon. While markets were stable in 2021, it is unlikely that such stability will continue in 2022.

Overall, the biggest risks for 2022 are inflation and the Fed. High stock valuations and covid are distant runners up in assessing risks for the year. The ever-present risk of an outside shock from a geopolitical event (Ukraine, Taiwan, etc.) remains as well. The PIMCO Funds Cyclical Outlook summarized the environment well, "Markets nonetheless appear priced for a blue-sky scenario where central banks achieve the elusive soft landing without any meaningful amount of rate hikes. Yet, history reminds us that sometimes 'stuff happens' when monetary policy pivots."

Fed Cycle Influences

Federal Reserve policy has had a marked influence on stock returns. Using history as a guide, the economy and financial markets should be shielded from dramatic changes from the new direction in Fed policy. Fed policy can be broken into four distinct phases that can be helpful in assessing the likely path of stock returns. The phases can be described as follows:

I – when monetary policy is easy, but the Fed is beginning to raise rates
II – when the Fed raises rates to a level that begins to restrict economic growth
III – after growth has slowed, the Fed begins to ease monetary policy to stimulate the economy
IV – when rates are already low, but the Fed continues to stimulate

The Fed is expected to raise the Fed Funds Rate several times in 2022. The exact timing is unclear, but the first increase is expected in March. Since rates have been pegged at zero since the onset of the pandemic, a few rate hikes likely fit into the definition of Phase I. However, if the Fed raises rates too quickly and begins to rapidly unwind the bond purchase program, the market may interpret such actions as too restrictive and trigger a broader correction.

Phase	Description	Stock returns	# of months
Phase I	Easy but tightening	8.1%	235
Phase II	Tight and tightening	-0.1%	126
Phase III	Tight but easing	0.9%	101
Phase IV	Easy and easing	12.8%	262
I & IV	Easy	10.6%	497
II & III	Tight	0.4%	227
I & II	Hiking	5.1%	361
III & IV	Easing	9.4%	363
All Phases		7.3%	724

Source: BCA Research

While the first several rate increases are not typically concerning for stocks, the pace and cumulative impact of Fed policy are big risks for the year. 2018 is an interesting analogy for the current monetary policy transition. In that year, the Fed raised interest rates four times and decreased the size of its balance sheet. The result was a -6% loss in the S&P 500, which is the worst calendar year return since the financial crisis in 2008. Volatility was also high in 2018. Stocks saw a -19.8% drawdown during that year – the biggest drawdown since 2010 other than the pandemic in 2020. A change in direction by the Fed will likely not be negative, but if the Fed moves too aggressively, it could generate uncertainty and be disruptive to financial markets.

Presidential Election Cycle is Weak in Mid-Term Years

One of the many explanations of market returns is the presidential election cycle. While not perfect, the cycle does seem to line up with the 2022 environment. Historically, the post-election year brings positive results from optimism after the conclusion of the election. In the second year, translating ideas into legislation turns out to be more challenging than expected. Monetary and fiscal stimulus typically lessen. The combination of disappointment and lack of stimulus weighs on markets. As a result, the mid-term election year is the weakest year in the four-year cycle. Since 1948, the S&P 500 is positive only 61% of the time, and the median gain per year was only 6.2%, significantly less than the other three years. The mid-term year tends to be even weaker in periods after the incumbent party loses an election.

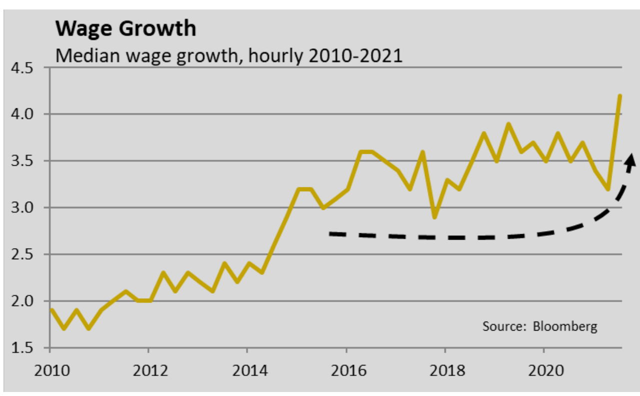
	Post Election Year	Mid Term Year	Pre-Election Year	Outgoing Election Year
Percent Up Years	63%	61%	89%	83%
Median Gain Per Year	9.1%	6.2%	18.1%	10.7%
Incumbent Party Wins (gain)	11.6%	8.5%	14.1%	9.7%
Incumbent Party Loses (gain)	4.8%	3.4%	19.4%	4.3%

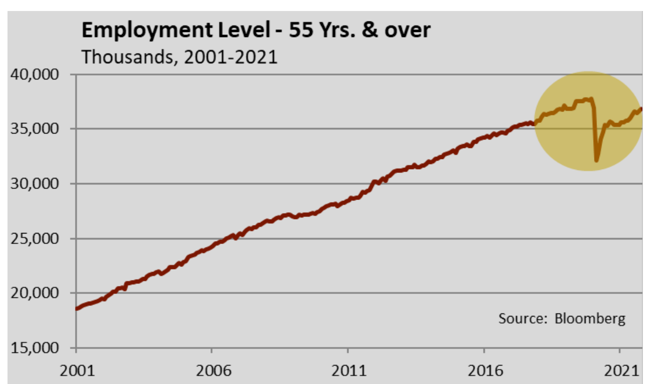
Source: Ned Davis Research

This trend is also seen in the outcome of mid-term elections, where the party of the sitting president tends to lose seats in Congress. Of the 30 elections since 1900, the President's party gained seats in Congress only 4 times.

Watching Wages and Employment

While the Fed continues to be focused on inflation concerns, there are many related indicators worth monitoring. Two interesting components that may provide insight into the inflationary environment are wage growth and employment for those age 55 and older.





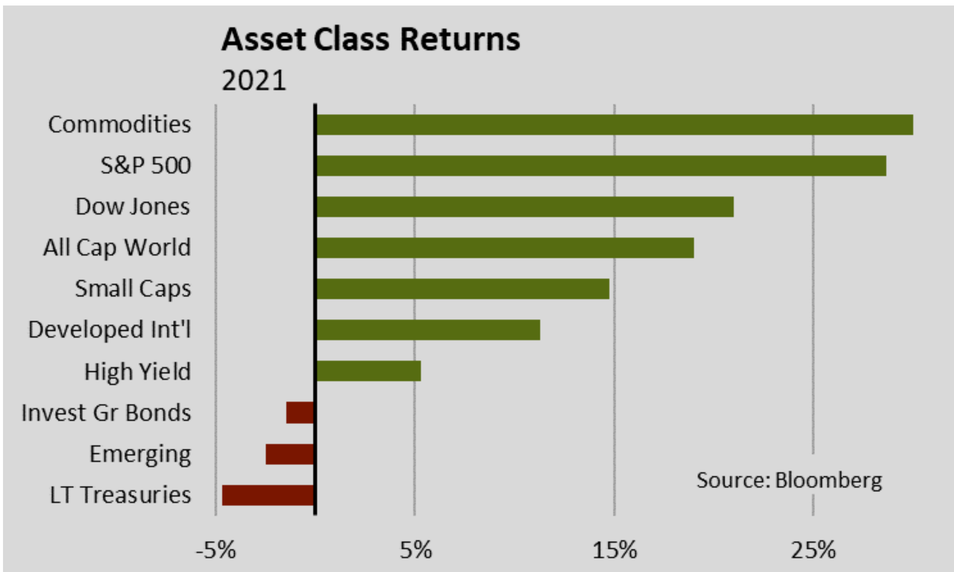
After the 2008 financial crisis, the Fed kept rates low to ensure wage growth would grow by enough to exceed inflation. It took several years, but by 2016, wages improved. Wage growth hit the highest level in over 10 years. Wages and inflation can be self-reinforcing, so excessive wage growth would be a concern.

The impact of the pandemic can also be seen in employment of those age 55 and older. A record number of people have left their jobs – a study by the Fed showed that over 3 million people retired earlier than expected. Employment statistics were very consistent over the past 20 years, but many baby boomers disrupted that trend. Fewer workers could exacerbate the pressure on wages and inflation.

Asset Class Returns

With fiscal and monetary stimulus as a tailwind, stock returns were strong in 2021. The S&P 500 generated a 28.7% return, while small caps and international stocks lagged at 14.8% and 11.3%, respectively. Emerging markets ended with a loss of -2.5%.

Since interest rates rose throughout the year, the bond market ended with losses in most sectors. Investment grade bonds lost -1.5%, and long-term treasuries lost -4.7%. Commodities are correlated with inflation, topping the list with a 30.1% return.



Negative returns for bonds are rare historically, but they can occur when interest rates rise. The negative returns for investment grade bonds of -1.5% was the third worst performance for bonds since 1980. Only 2013 and 1994 were worse, realizing losses of -2.0% and -2.9%, respectively. Additionally, bonds had a tough first week to start to 2022. After five trading days, the 10-year Treasury Note had its worst week in 42 years, losing -4.2%.

Seasonality was a factor in 2021. The winter strong season (comprised of January through April plus October through December), generated most of the positive return for the year at 23%. The traditionally weaker summer months (May through September) returned only 4%.

Final Thoughts

While many of the challenges for 2022 seem familiar, financial markets are still in uncharted territory. Some companies have fully recovered from the 2020 recession; at the same time, the pandemic continues to severely restrict many service-oriented businesses. Pandemic-driven supply shortages caused a short-term inflationary surge, and the Fed responded by announcing the removal of monetary stimulus.

The good news is that the pandemic is likely to have a diminishing impact on financial markets. The bad news is that financial markets will need to walk a fine line. The economy will need to absorb ongoing pandemic risks with less financial stimulus. The stock market reached an all-time high in December, and stock valuations are expensive.

Financial markets will have to navigate the removal of monetary stimulus, inflation fears, and an ongoing pandemic. While the known risks are big challenges, it is typically the unexpected surprises that drive major swings in financial markets.

If you have questions on the investment environment or your portfolio, please call us at 734-769-7727. To find an electronic copy of this document and other recent commentaries, please visit our website at www.risadvisory.com.

Brock Todd John Pam Evan Megan Karen

Brock E. Hastie
Managing Partner

Karen Chapell
Managing Partner

Todd Kephart
Managing Partner

John Goff
Managing Partner

Pamela Loduca-Massa
Sr. Vice President

Evan LeRoy
Portfolio Manager

Megan Flynn
Portfolio Manager