Fourth Quarter 2021 Key Takeaways

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The renewed surge in COVID-19 infections late in the year and China's policy-induced economic slowdown and stock market decline were key drivers of international equities poor relative performance in 2021.

For 2021, BCA Flexible model portfolios generated solid absolute performance but returns trailed the U.S. Equity benchmark, mostly as a result of BCA model holdings in international developed and emerging market stock funds

The biggest positive contributor the performance for the BCA Flexible models was our position in the Schwab U.S.

Dividend Equity fund, which earned 29.78% for the year**.**

COVID-19 remains a key variable for the *near-term* (12-month) global economic and market outlook. The most likely *medium-term* (multiyear) base case is for continued progress in the fight against the virus and therefore a lessening of its economic impact over time.

After unprecedented stimulus in 2020 and 2021, both fiscal and monetary policy levers in the United States are set to tighten in 2022. But they should not become so tight as to cause a recession.

The consensus forecasts for economic growth and inflation in 2022 envision decelerating growth and moderating inflation, but both still meaningfully above the economy's longer-term trend.

Earnings-per-share (EPS) growth will sharply *decelerate* for the S&P 500 in 2022 compared to 2021. But it should still be at least around or above its historical trend growth rate of roughly 6% and in line with the current consensus expectations of 8%–9% for 2022.

Expect international and emerging stock markets to outperform the S&P 500 in 2022, due to their (1) higher cyclical sensitivity to global economic growth, (2) their larger potential for earnings acceleration and positive earnings surprises after lagging U.S. stocks the past several years, and (3) their much lower starting equity market valuations.

Overall, balanced portfolios are well-positioned with (1) a moderate overweight to global equities, due to a tactical overweight to emerging market stocks; (2) a large overweight to a bond-alternative fund, to hedge against rising interest rates; (3) core positions in lower-risk U.S. dividend paying companies; and (4) a large underweight to core bonds, to hedge against rising interest rates.

Fourth Quarter Market Recap

It’s been another remarkable year for the S&P 500 Index. Not only did the index of large-cap U.S. stocks return a stunning 28.7%, nearly triple its long-term historical average, but for only the second time in market history, the index reached a new high in each and every month.

The S&P 500 also dominated U.S. small-cap stocks (Russell 2000 Index, up 14.8%), developed international stocks (MSCI EAFE Index, up 11.3%), and emerging-market (EM) stocks (MSCI EM Index, down 2.5%) for the year. Much of this outperformance occurred in the fourth quarter, with the S&P 500 gaining 11.0%, compared to 2.1%, 2.7%, and -1.3% for small caps, developed international stocks, and EM stocks, respectively.

The renewed surge in COVID-19 infections late in the year (particularly in Europe and emerging markets) and China’s policy-induced economic slowdown and stock market decline were key drivers of this relative performance. The MSCI China Index plunged 21.7% for the year and lost 6.1% in the fourth quarter. Chinese stocks comprise roughly 35% of the MSCI EM Index. The MSCI EM ex-China Index gained 10.0% for the year.

Also contributing to the underperformance of international stocks for U.S.-based investors was the strength in the dollar. After falling early in the year, the U.S. dollar index appreciated sharply, ending the year with a 6.3% gain. A rising dollar is a negative when translating foreign market local-currency returns into U.S. dollar-based returns.

Looking beneath the surface of the U.S. market, the large-cap Russell 1000 Value and Growth indexes both returned over 25% in 2021, but the strong rally in growth stocks in the second half of the year gave it a slight edge over value once again for the year. However, two of the three top-performing sectors were cyclical value sectors: energy (up 54.6%) and financials (up 35.0%). The other top-performing sectors were real estate (up 46.2%) and information technology (up 34.5%). The worst-performing sectors were traditional “defensive” sectors: utilities (up 17.7%) and consumer staples (up 18.6%).

Turning to the bond markets, the core bond index (Bloomberg US Aggregate Bond Index) lost 1.5% for the year, as interest rates rose moderately (in other words, bond prices fell). The benchmark 10-year Treasury bond yield ended the year at 1.51%, compared to a 0.92% yield at the end of 2020. Given the very sharp rise in inflation, most pundits would not likely have predicted such a mild increase in bond yields.

Credit markets, the markets for bonds issued by entities other than governments and municipalities, fared much better than core bonds in 2021. The U.S. high-yield bond index returned 5.4% (ICE BofA ML High Yield Cash Pay Index) and the floating-rate loan index gained 5.2% (S&P/LSTA Leveraged Loan Index). These returns were consistent with our expectations given a recovering and growing economy.

Portfolio Performance & Key Performance Drivers

For 2021, our BCA Flexible model portfolios generated solid absolute performance but returns trailed the U.S. Equity benchmark, mostly as a result of BCA model holdings in international developed and emerging market stock funds, whose performance significantly trailed the U.S. stock market for the year.

Also hurting performance was, for our more growth-oriented models, a position in the ARKK Innovators fund, a U.S. stock fund, which managed to lose 23% in a year when the S&P 500 index gained 28.7%. The Innovators fund has earned spectacular longer-term performance, but suffered in 2021 due to a not-entirely-unexpected sell-off in companies whose stock prices soared in 2020 as a result of the shift toward a remote-work environment to combat the spread of COVID. Fortunately, the ARKK fund is a small position in most models, after our February 2021 sale of 50% of the position, a timely move as it turns out.

The biggest positive contributor the performance for the BCA Flexible models was our position in the Schwab U.S. Dividend Equity fund, which earned 29.78% for the year. This Schwab fund is the largest equity holding in all of our model portfolios, so the fund's outperformance was central to overall model performance for the year.

Also a positive contributor to performance was our tactical position in the J.P. Morgan Hedged Equity fund, a bond-alternative holding which earned 13% in a year when the aggregate bond index suffered a loss of 1.50%. This position helped offset the drag on model performance of most bond holding for the year.

Our Dividend Payers portfolios generated both solid absolute and relative performance for the year, as these portfolios are largely invested in U.S. stocks. 2021 returns for the individual positions in our portfolios ranged from +86% for Seagate Technologies, to -7% for AT&T.

In the rest of this commentary, I'll walk through three key elements of the U.S. and global macro backdrop: (1) COVID-19, (2) U.S. economic policy, and (3) growth and inflation. I'll then turn to how these and other factors inform my current outlook for the financial markets. I'll recap our portfolio positioning and performance expectations and conclude with an update of my views on EM equities and China in light of the recent market headlines and regulatory developments there.

My Macro and Market Outlooks for 2022 and Beyond: I Remain Cautiously Optimistic at this (Mid-)Stage of the Cycle

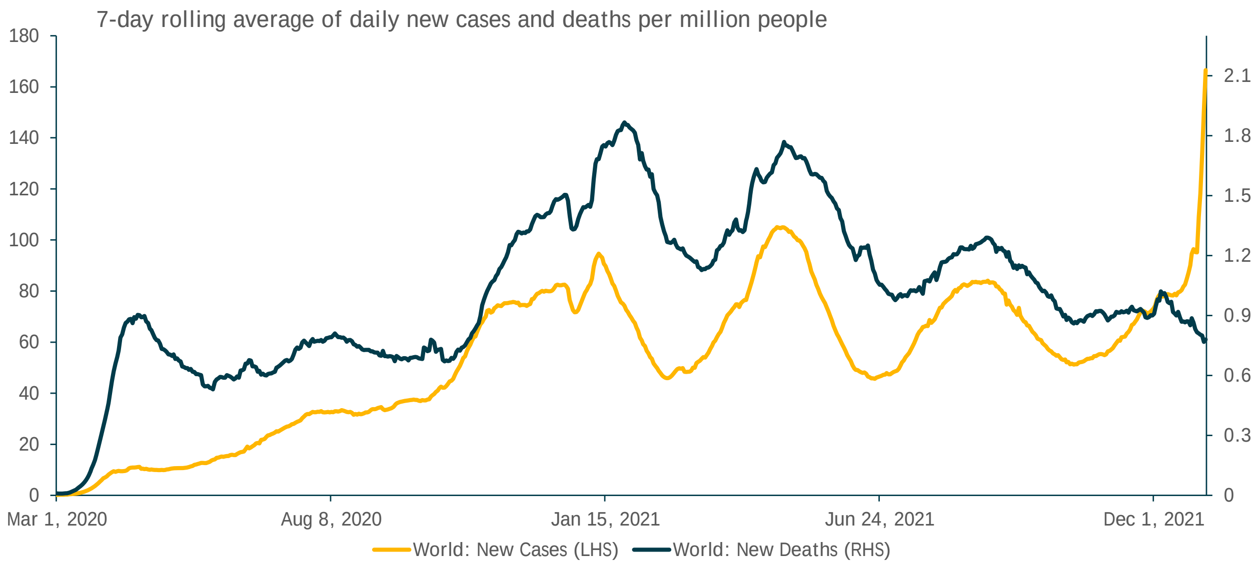
The Macro Backdrop

COVID-19:

As has been the case for the past 21 months, COVID-19 remains a key variable for the *near-term* (12-month) global economic and market outlook. I still believe the most likely *medium-term* (multiyear) base case is for continued progress in the fight against the virus and therefore a lessening of its economic impact over time. (New antiviral drugs are the latest positive medical development.) Nor, based on prior waves, do I foresee the Omicron variant derailing the economic recovery in 2022, although it looks likely to have a negative impact early in the year.

If the pandemic recedes in 2022 as seems likely, the current pandemic-related supply chain disruptions, U.S. labor market anomalies, and consumer demand distortions should also recede. This should both support overall economic growth and mitigate at least some of the inflationary pressures the U.S. and global economies experienced in 2021 related to supply/demand mismatches.

However, as I said last quarter, we are not out of the COVID-19 woods by any means. Even as global vaccinations and immunity rise and societies adapt, the risk remains of new, more contagious and/or more deadly variants emerging. We are facing that now with Omicron, which is even more contagious than the Delta variant (but seemingly less virulent). And we'll continue to see disparate virus impacts across countries, economies, and industries, along with differing government responses. For example, in the last weeks of December, several European countries and China enacted new lockdowns and other restrictions on activity as Omicron cases surged.



U.S. Economic Policy:

In addition to the evolution of the pandemic, U.S. monetary and fiscal policy will have important impacts on economic growth, inflation, and the financial markets in 2022. After unprecedented stimulus in 2020 and 2021, both policy levers in the United States are set to tighten in 2022. But they should not become so tight as to cause a recession.

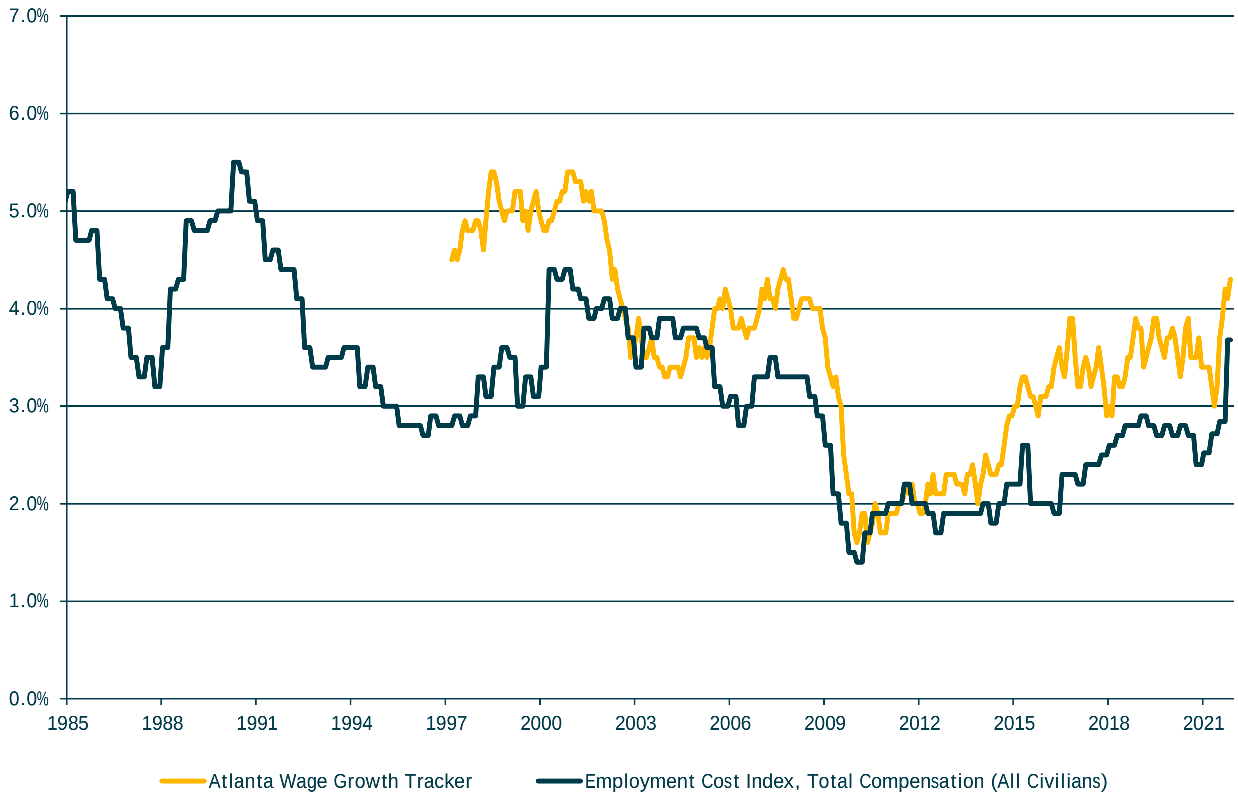
Monetary Policy:

At its December Federal Open Market Committee (FOMC) meeting, the Federal Reserve expressed increasing concern about inflation and signaled it would accelerate its timeline and pace for interest rate hikes in 2022. Also, as expected, the Fed doubled the monthly pace of reducing (tapering) its quantitative easing asset purchases (QE); QE should end in March 2022, if not earlier. More hawkish than the accelerated taper, the updated Fed member "dot plot" now indicates a median of three rate hikes in 2022 (up from only one at the last FOMC meeting in September) and three more in 2023.

Of course, these are subject to change—and the track record of the dot plot in predicting the Fed's *actual* behavior a year or two out is abysmal. But the dots indicate the Fed's current collective mindset and expectations given the individual members' reading of the economic tea leaves and where they expect the economy, unemployment, and inflation to be six to 12 months hence. Why is this important? Because financial markets pay a lot of attention to interest rates.

In his comments after the FOMC meeting, Fed chair Jerome Powell noted that core inflation has broadened beyond the industries most impacted by the pandemic and is well above the Fed's 2% average inflation target. He also cited a range of economic indicators that suggest the labor market is rapidly tightening (for example, a falling unemployment rate, rising wage growth, abundant job openings, and high employee quit rates). "In my view," said Powell, "we are making rapid progress toward maximum employment."

Fed Chair Powell Expressed Concern About Recent Wage Inflation Readings



Source: Federal Reserve Bank of Atlanta and Bureau of Labor Statistics. Data as of 11/30/2021.

With both its inflation and full employment mandates likely to be met, the Fed will be in position to start tightening monetary policy (raising rates and reducing their balance sheet assets) in 2022.

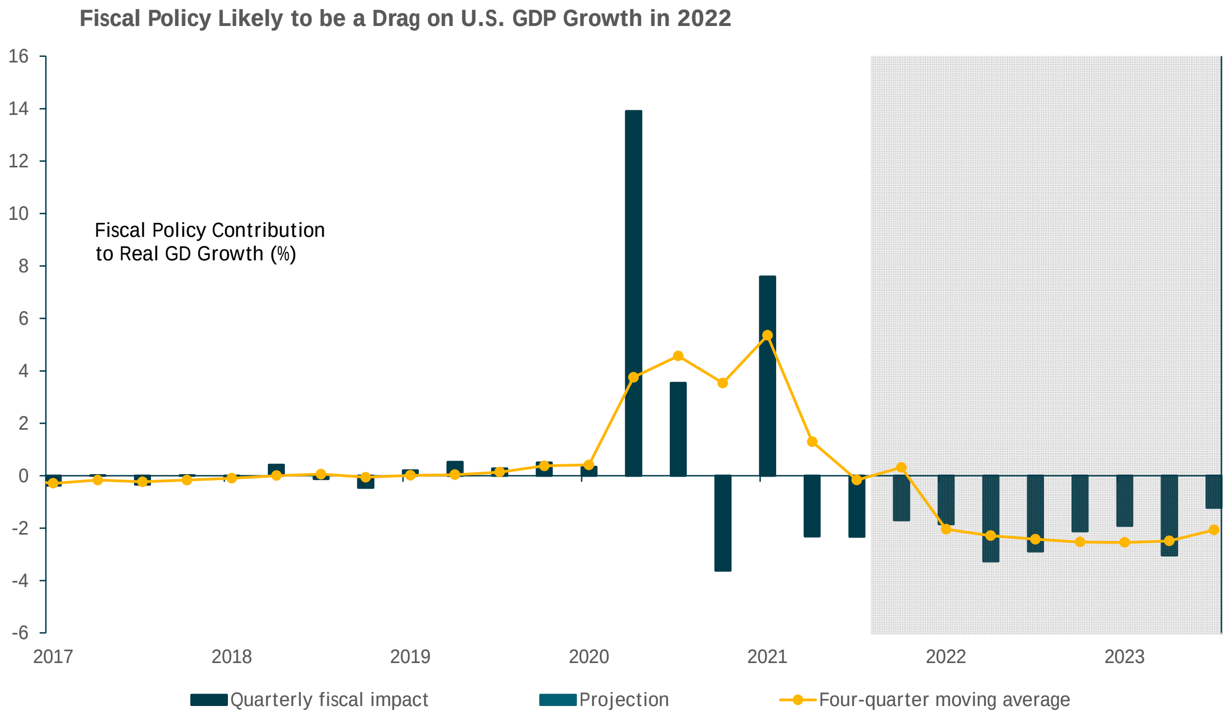
Outside the United States, nearly half of all global central banks have already started raising interest rates. Notable exceptions are the European Central Bank (ECB) and the Bank of Japan (BoJ), both of which have signaled no intention to tighten any time soon given the state of their economies.

Importantly, China's central bank (People's Bank of China) has begun to modestly *loosen* policy—cutting interest rates and banks' reserve requirement ratio—in response to weak economic data. China's recent economic slowdown is due to both the government's regulatory clampdown on the speculative but very large property/housing sector and their extreme "zero-COVID" policy in response to new variant outbreaks. China's policy easing/stimulus is likely to accelerate in 2022, although it's unlikely to be of the magnitude seen in response to China's previous cyclical slowdowns in 2008, 2012, 2015, and 2020.

Fiscal Policy

Fiscal policy is also set to turn from a tailwind to a headwind for U.S. GDP growth in 2022. This is not to say the United States won't have another large budget deficit this year, but we'll see less stimulus *relative to the huge fiscal boost from 2020-2021*, 2022. This will amount to a "fiscal drag"—a negative impact on GDP growth next year. For example, the Hutchins Center on Fiscal and Monetary Policy in Washington estimates the fiscal drag will be around 2.5 percentage points of GDP. Further, with the passage of the Build Back Better legislation now in doubt (as of late

December), economists have started to factor in an even larger fiscal drag, reducing their forecasts for 2022 GDP growth.



Source: Hutchins Center on Fiscal and Monetary Policy and Brookings Institution.

Economic Outlook

The consensus forecasts for economic growth and inflation in 2022 envision decelerating growth and moderating inflation, but both still meaningfully above the economy's longer-term trend. From an investment portfolio perspective, this macroeconomic backdrop should again be generally supportive for "risk asset" returns, such as global stock and credit markets, and a headwind for core bond returns in the face of rising government bond yields.

According to Bloomberg's survey of economists, the consensus expects roughly 4% real GDP growth for the United States (same as the FOMC's forecast) and slightly higher growth for Europe in 2022. This compares to around 5.5% (U.S.) and 5% (Europe) growth in 2021. Total global real GDP grew at roughly 5.6% in 2021—its fastest pace since 1980—and the consensus expects growth in the 4.5%–5.0% range in 2022.

While I don't make GDP forecasts, I'm comfortable with these as reasonable ballpark baseline estimates, given the macro backdrop described above. They reflect the inevitable slowing of growth after the historic pandemic rebound but would still be well above the estimated long-run potential (or normalized) real growth rate of around 1.5%–2% for the U.S. and other developed economies, and around 3.5% for the overall global economy.

Economic forecasts for inflation next year appear to be more varied than for growth, and my crystal ball is no clearer than anyone else's. But again, I don't need to try to precisely predict inflation each year; my investment process and portfolio management approach don't depend on such short-term economic forecasts. Moreover, as I've often said, one can get the macro right and still get the markets wrong. (To pick a few recent examples, with headline U.S. inflation soaring from under 2% to 7% in 2021, who would have forecast the 10-year Treasury yield would end the year at 1.5%, gold would be down 4% for the year, or the U.S. stock market would return 29%?)

That said, as long as the pandemic recedes over the year, the core inflation rate is almost certain to decline as pandemic-induced supply/demand distortions normalize, even if things aren't all the way back to "normal."

However, as I've discussed in prior reports, the "shelter" price component of the consumer price index (CPI) is almost certain to rise further in 2022 because it lags housing price inflation, and home prices rose nearly 20% in 2021. (Shelter accounts for roughly 40% of core CPI.)

And with labor markets tightening toward full employment, wages and labor costs could also see stronger upward pressure, which could feed into consumer goods and services prices.

All in all, my best guess is that core consumer inflation is likely to be closer to 3% than 2% next year and may remain above 2% on a more sustained basis going forward.

That is my current base case. The data I cited earlier doesn't suggest we are seeing a damaging "wage-price-expectations inflationary spiral." The Fed's hawkish pivot also weighs against that outcome (as long as Powell's bite follows his bark). But my view isn't set in stone—it continuously evolves and adapts as new data and evidence comes in.

Most importantly, as I evaluate investment opportunities and manage client portfolios, I always consider a range of risks and alternative scenarios *outside of my base case.* Building a diversified portfolio that is resilient across a range of potential outcomes while positioned to benefit should my base case play out is my objective.

I see the following key macro risks around my cautiously optimistic base case for 2022:

- A new highly infectious and deadly COVID-19 variant emerges. Omicron also poses a near-term risk to the global outlook. Because of its very high transmissibility, there is a risk of overwhelming hospital capacity, leading to renewed lockdowns with resultant economic and social impacts.
- A wage-price inflation spiral starts to emerge; longer-term inflation expectations rise beyond the Fed's comfort zone.
- The Fed makes a policy mistake: Either (1) the Fed tightens too much/overreacts to inflation readings; or (2) the Fed allows inflation to become entrenched (wage-price inflation spiral).
- The Chinese economy has a sharp downturn ("hard landing"), for example, due to a policy mistake related to the property-market deleveraging.
- A geopolitical or exogenous shock impacts the global economy (always a possibility).

Let's now turn to the financial market and investment implications of my base-case macro-outlook and the risk scenarios around the base case.

Financial Markets Outlook

Base Case

Over the next year at least, barring a global macro shock, I expect positive returns for global equity and credit markets (and risk assets in general), driven by continued corporate earnings growth that underlies these assets. In this base-case scenario, the 10-year Treasury yield is likely to moderately rise, which means another poor year for core bond returns, both in absolute terms and relative to other asset classes and alternative strategies.

Earnings-per-share (EPS) growth will sharply *decelerate* for the S&P 500 compared to 2021. But it should still be at least around or above its historical trend growth rate of roughly 6% and in line with the current consensus expectations of 8%–9% for 2022. I think this is reasonable because (1) corporate revenue (topline) growth should be consistent with nominal GDP growth (real GDP growth plus inflation) in the mid to upper single digits; (2) profit margins should remain near historically high levels but will depend on companies' ability to pass through higher input and wage costs or increase productivity and profitability via capital investments; and (3) share buybacks are likely to boost the S&P 500 EPS by a few additional percentage points.

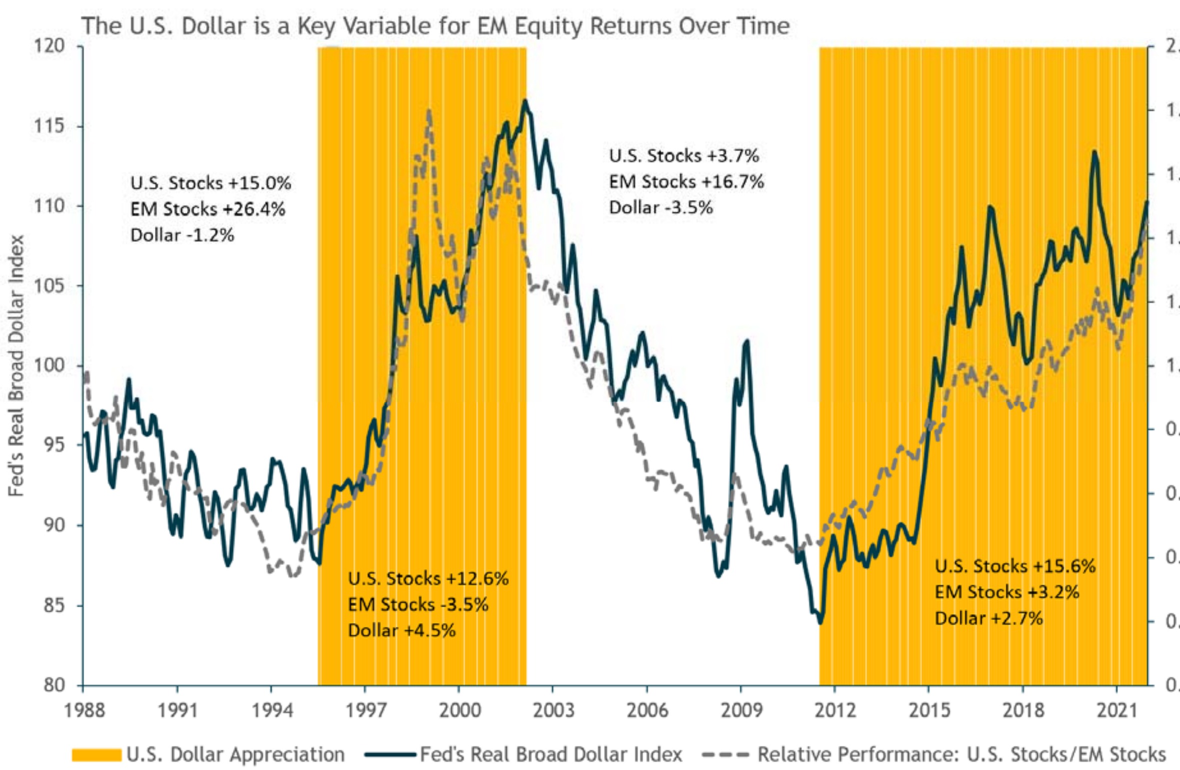
Monetary and fiscal policy in the United States will become less accommodative but is unlikely to tighten so much (yet) that it triggers a bear market and economic recession.

As always, equity investors should expect market volatility and be prepared for 10%-plus drawdowns ("corrections"). But absent a recession, a 20%-plus bear market is unlikely.

I expect international and emerging stock markets to outperform the S&P 500, due to their (1) higher cyclical sensitivity to global economic growth, (2) their larger potential for earnings acceleration and positive earnings surprises after lagging U.S. stocks the past several years, and (3) their much lower starting equity market valuations.

As such, I see the likelihood for strong returns to foreign markets from both improving fundamentals (cyclical earnings rebound) and, as investor sentiment improves, higher valuations (price-to-earnings multiples) over the coming year(s).

Another key variable for the performance of foreign equity markets, and emerging markets in particular, is the direction of the U.S. dollar. As noted in our 2021 market recap at the top, the dollar's strength this year was a major headwind to foreign equity market returns for U.S. dollar-based (unhedged) investors, as their returns are translated from weaker foreign currency terms into a stronger dollar.



Source: Board of Governors of the Federal Reserve System and Morningstar Direct. Data as of 12/31/2021. Returns are reported in annualized numbers.

Forecasting the short-term twists and turns of the global currency markets is a fool's errand. But as the chart below shows, the broad dollar index has tended to move in longer-term multiyear trends, driven by macro fundamentals and shorter-term price momentum.

I won't try to time the next inflection point for the strong-dollar trend to reverse, but my base case is consistent with it happening within the next year or so due to several factors:

- The dollar is a counter-cyclical (safe-haven) currency. Therefore, if/as the global economy grows above-trend in 2022 and with a stronger rebound in growth outside the United States—as those economies have more room to catch up from the pandemic losses—the dollar should depreciate.

- The growing U.S. twin deficits—federal budget deficit and trade deficit—should put downward pressure on the dollar.

- On a fundamental (purchasing power parity) basis, the dollar is overvalued.

- The dollar is a high-momentum currency, but bullish dollar positioning in the markets is now reaching extremes and ripe for a sentiment reversal.

- The Fed has recently turned more hawkish on inflation and monetary policy, which has boosted the dollar. But it remains to be seen what they actually do in terms of rate hikes next year. For example, there is potential for a dovish surprise relative to current market expectations of three rate hikes.

Another key driver for EM equities is the performance of China's economy and stock market. This really hurt EM index returns in 2021, as I noted above. I think the most likely scenario is increased Chinese policy stimulus in 2022, which should boost China's economy and stock market and support broader EM economic growth and equity markets.

One widely followed leading indicator for China's economy and markets is the China credit impulse, which measures the change in newly issued public and private credit (the flow of credit) as a percentage of GDP. The credit impulse tends to lead turning points in China's economic activity by roughly six to nine months.

Portfolio Positioning

Portfolios remain positioned to benefit from my highest-conviction *tactical* investment opportunities. But portfolios are also *strategically* balanced and well-diversified across a range of global asset classes, alternative strategies, and risk-factor exposures. This should enable them to be resilient should a risk scenario or shock outside our base case occur.

Overall, balanced portfolios are positioned with (1) a moderate overweight to global equities, due to a tactical overweight to emerging market stocks; (2) a large overweight to a bond-alternative fund, to hedge against rising interest rates; (3) core positions in lower-risk U.S. dividend paying companies; and (4) a large underweight to core bonds, to hedge against rising interest rates.

Within my global equity allocation, I continue to maintain balanced allocations between slow-growth and fast-growth companies through the funds I've chosen. There is no particular emphasis on sectors, as I lack the conviction to make this kind of bottom-up bet on a particular sector. That said, I do see potential for slow-growth ("value") and cyclical stocks to rebound (again) as COVID-19 recedes and interest rates rise. And slow-growth stocks in aggregate still look very cheap versus fast-growth stocks. But I also want to maintain exposure to high-quality, innovative growth companies with strong competitive advantages - thus a continued position in the ARKK Innovators fund.

With regard to my tactical overweight to emerging market stocks, I am in the process of revisiting this position in light of the *near-term* risks highlighted above (COVID-19, China policy/property deleveraging, Fed monetary tightening, dollar appreciation). My five-year expected return scenario for emerging market stocks already incorporates these risks, and I believe my base-case assumptions stand a decent chance of playing out, in which case I see significant outperformance of emerging market stocks, but it's worth reviewing this position in light of current risks. I expect to decide on this in early 2022. (Of course, all tactical allocation assessments are *always* an ongoing process.)

Portfolio fixed-income positioning reflects my poor outlook for the core bond index: The index is starting from a low sub-2% yield and interest rates are likely to rise over the coming quarters, at least until a recession hits. The J.P. Morgan Hedged Equity bond-alternative fund, in my view, stands a strong likelihood of outperforming the bond index in the coming years. But I still maintain a meaningful core bond allocation as a hedge against a significant stock market decline.

Closing Thoughts

In summary, your portfolios are well-positioned to generate attractive returns in my base-case macro and market scenarios in which the pandemic recedes (but doesn't disappear), the global economy slows but still grows above trend, corporate earnings growth slows but is still solid, the U.S. rate of inflation remains elevated but is falling, and U.S. interest rates rise moderately.

That would be somewhat of a "goldilocks" scenario for the economy and global equity and credit markets, although not for the core bond market. But even in the best case, it likely won't be a smooth journey: The pandemic remains uncontained, domestic and global political and social tensions are elevated, the risks of an economic policy mistake have risen, and any number of other inevitable yet unpredictable bumps in the road may occur.

I am confident in my investment process and ability to navigate whatever comes our way, with the objective of achieving your investment and financial goals. I sincerely appreciate the confidence and trust you have placed in me. I never take that for granted.

I wish you and yours a healthy, happy, peaceful, and prosperous 2022.

Best,
Kelly D. Kane, ChFC, CFP