December 31, 2021

Quarterly Market Review

It's a hat-trick! 2021 marks three consecutive years of double-digit gains for the U.S. Equity market. The S&P 500 recorded a 28.7% gain for 2021, 18.4% for 2020 and 31.5% for 2019 for a cumulative gain of 100.4% for the three years. An historic event for the equity market which has only occurred four times since 1928. By comparison, the equity market dot.com run from 1995 to 1999 takes the prize with a 202% cumulative return.

The record setting performance for the equity market can be attributed to several factors, strong earnings growth, unprecedented fiscal and monetary stimulus, healthy and improving consumer balance sheets and negative real bond yields make fertile ground for equity investors.

Bonds on the other hand are facing a seemingly trifecta of headwinds with rising inflation, a secular shift toward monetary policy tightening and negative real bond yields all make a positive real return in bonds a very difficult proposition for 2022.

With the omicron variant grabbing most of the headlines in 2021 and introducing a bout of volatility during the final quarter of the year, investor focus will be on the Federal Reserve for 2022. Market participants are calling for four ¼ point increases from the Fed in 2022 and continued reduction of its $8.6 trillion balance sheet as the Central Bank attempts to contain an inflation problem: A problem that is being aggravated by tight labor market conditions, supply chain disruptions, rising wages and surging home values.

Another notable observation during Q4 was a rotation in the equity market from growth to value, which has continued into the new year. Rising interest rates will act as a discounting mechanism for all financial assets. Stocks that pay/grow dividends and generate healthy levels of free cash flow will likely outperform stocks that don't pay dividends and typically trade at the upper end of historic valuation metrics.

Looking into 2022, we see several key macro themes for the capital markets: (1) Persistent and rising inflation (2) Tightening monetary policy (3) Supply chain challenges (4) Tight labor market conditions. As such, valuation will be in greater focus as investors assess how these factors will impact asset allocation decisions (bonds versus equities) as well as security selection or active management decisions.

Lastly, investors should prepare for higher levels of volatility compared to 2021 with the possibility of exogenous shocks emanating from other COVID mutations like omicron as well as geopolitical uncertainty in Russia and China.

Global Economic Outlook *

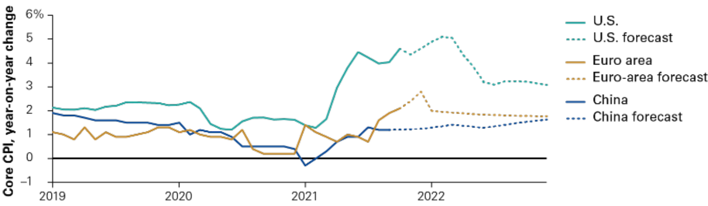
Although health outcomes will remain important in 2022 given the emergence of the Omicron variant, the outlook for macroeconomic policy will be more crucial as support and stimulus packages enacted to combat the pandemic-driven downturn are gradually removed into 2022. The removal of policy support poses a new challenge for policymakers and a new risk to financial markets. Central banks will have to maintain the delicate balance between keeping inflation expectations anchored and allowing for a supportive environment for economic growth.

While the global economic recovery is likely to continue in 2022, we expect the low-hanging fruit of rebounding activity to give way to slower growth whether supply-chain challenges ease or not.

Inflation has remained high across most economies, driven both by a higher demand as pandemic restrictions were lifted and by lower supply resulting from global labor and input shortages.

A return to 1970s-style stagflation—stagnant economic activity amid high unemployment and inflation—is not in the cards. Vanguard continues to anticipate economic growth and, unlike in the 1970s, demand for workers is high. We expect inflation to remain elevated across developed markets as the forces of demand and supply take some time to stabilize.

Although inflation should cool in 2022, its composition should be stickier. More persistent wage-and housing-based inflation should remain elevated given our employment outlook and will be the critical determinant in central banks' adjustment of policy. (See figure below)



Stocks: Valuations and Projected Returns

With valuations that have exceeded pre-pandemic highs, elevated inflation and the prospect of policy normalization are creating a fragile backdrop for markets. Our long-term outlook for global asset returns is guarded. This is especially true for equities, where high valuations and lower economic growth rates mean we expect lower returns over the next decade.

The relative attractiveness of equity market segments

U.S. equities have outperformed our forecast, pushing our future return expectations lower, while international equities have underperformed, pushing expectations higher. U.S. equities have not been this overvalued since the dot.com bubble.

Despite the global divergence in health and economic outcomes, we believe that there is a high probability that international equities will outperform U.S. equities in the coming decade. Broad emerging-market valuations appear to be stretched based on its relationship with aggregate inflation, real U.S. short-term yields, the spread between emerging-market and U.S. central bank policy rates, economic conditions, and equity market volatility.

We expect value stocks to outperform by as much as the historical equity risk premium over the next decade, mostly because of a decay in the overvaluation of growth stocks, not because the "fair value of value" has returned to historical norms.

Bonds: Valuations and Projected Returns

For fixed income, low (by historical standards) interest rates mean that investors should expect lower returns. However, the fact that rates have risen modestly since 2020 means that our outlook is commensurately higher.

Against that backdrop of gradually rising rates, the fixed income return outlook in the next decade has been ticking up from last year's projections. Valuation expansion has chipped away at investors' sources of extra yield however, higher rates have pushed expected fixed income returns higher.

The relative attractiveness of fixed income market segments

Expected returns for non-U.S. bonds are marginally lower than for those of U.S. bonds, given the relatively lower yields in non-U.S. developed markets. But the diversification through exposure to hedged non-U.S. bonds should help offset some risk specific to the U.S. fixed income markets.

Broad U.S. investment-grade bonds should outperform U.S. Treasury bonds by 50 basis points on an annualized basis. Importantly, although future returns for fixed income remain at historic lows, the COVID-19 crisis reaffirmed the role bonds play in a portfolio.

Within the U.S. aggregate bond market, investors are still expected to be compensated for assuming credit risk, though by about half as much as we suggested in 2020, resulting from continued tightening in credit spreads. Treasury Inflation-Protected Securities (TIPS) appear less attractive than last year from a return perspective amid moderated inflation expectations but could be a valuable inflation hedge for some sensitive to inflation risk.

Caution is warranted when reaching for yield. High-yield funds are expected to return only one percentage point over Treasuries, but with volatility that is more than two times higher. With a negative correlation with equities that is similar to Treasuries, mortgage-backed securities are projected to deliver a higher yield than Treasuries as compensation for bearing interest-rate volatility risk.

Capital Markets Scorecard

Benchmark Description	Q4	2021
U.S. Treasury 3 Month T-Bill	0.01%	0.04%
Barclays Aggregate Bond Index	-0.27%	-1.54%
Barclays US High Yield Corp Bond	0.71%	5.28%
S&P 500 Index Total Return	9.77%	28.71%
NASDAQ Composite TR	7.57%	22.18%
NASDAQ Dividend Achievers TR	11.24%	23.76%
Russell 2000 Index TR	0.44%	14.82%
Alerian MLP Index TR	-0.87%	40.17%
U.K. FTSE 100 Index LC	5.63%	18.44%
German DAX Index LC	4.81%	15.79%
China SCI 300 Index LC	1.61%	-3.52%
Japan Nikkei 225 Index LC	0.24%	6.66%
MSCI Emerging Markets USD	-0.25%	0.10%

*Market Scorecard data as of 12/31/2021. Stokes Capital Advisors, LLC is a Registered Investment Adviser. * Global Economic Outlook provided by Vanguard Capital Markets Group. This market commentary is solely for informational purposes. Advisory services are only offered to clients or prospective clients where Stokes Capital Advisors, LLC and its representatives are properly licensed or exempt from licensure. Past performance is no guarantee of future returns. Investing involves risk and possible loss of principal capital. No advice may be rendered by Stokes Capital Advisors, LLC unless a client service agreement is in place.*

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