DANN ASSET ADVISORS, LLC

Fourth Quarter 2021 Update

January 12, 2022

4Q21 Highlights

- Despite December volatility the S&P 500 logs a seventh straight quarterly gain
- Supply chain issues begin improving but inflation remains high
- Inflation and a tight labor market lead the Fed to accelerate monetary tightening
- Fiscal stimulus diminishing unless Build Back Better is resuscitated and passed in 2022
- Covid variants likely to cause continued ebbs and flows in economic growth

The table below summarizes the performance of some key indices during the fourth quarter and year to date:

Market Performance		
Index	% Ch. 4Q21	% Ch. YTD
S&P 500	11.0	28.7
Russell Mid-Cap	6.4	22.6
Russell 2000 (small cap)	2.1	14.8
MSCI All Country World ex US	1.8	7.8
US Aggregate Bond	0.0	-1.5
High Yield Corporate Bond	0.7	4.5

Source: Morningstar, iShares

<u>Equities</u>. The S&P 500 index of the largest U.S. stocks had another strong quarter, resulting in a 28.7% return for the year. Coming on top of gains of 31.5% and 18.4% in 2019 and 2020, respectively, it has been a very strong stretch for large-cap U.S. stocks. The market's 30%-plus decline in February/March of 2020 seems a distant memory, overshadowed by the favorable impacts of unprecedented, supportive monetary and fiscal policies.

Consistent with trends that have been in place for most of the past three years, small company and international stocks badly trailed the S&P 500 during the quarter. Small-cap stocks had a brief positive burst early in the fourth quarter but finished the year lower than levels first reached in March. International stocks peaked in June and then drifted lower over the remainder of the year.

Large cap value stocks (as measured by Russell 1000 indices) returned 25.2% for the year, modestly trailing the growth index's 27.6% return. Value had been leading growth by 406 basis points (a basis point is 1/100th of one percent) through June 30. Value and small cap stocks usually are considered especially sensitive to economic growth, so these two sectors' relatively poor performance over the second half of 2021 may be a reflection of economic growth having peaked last summer.

<u>Fixed income</u>. Ten-year treasury yields ranged from 1.34% to 1.68% during the quarter as the market reacted to more aggressive monetary policy from the Fed and Omicron's potential negative impact on the economy. Despite the fluctuations, the 10-year ended the quarter at 1.51%, essentially unchanged from 1.53% on September 30. The 10-year had begun 2021 at 0.92%, so there was a material move higher but rates remain low compared with historical

levels. Two-year treasury yields rose from 0.29% on September 30 to 0.73% at year end, a big move that reflects the Fed's greater influence over shorter term rates. Two-year treasuries began 2021 yielding only 0.12%.

With the increase in rates, it was a poor year for fixed income, as indicated by the negative full year return for the Barclays U.S. Aggregate Bond index. High yield bonds with their higher coupons generated modest but positive returns for the year. The spread between high yield and investment grade bonds remains at historically low levels, with just a 3.10 percentage point difference on December 31[(1)].

Market sectors[(2)]. Real estate investment trusts (REITs), technology, and materials were the three best performing sectors in the fourth quarter, with each gaining 14% to 15%. Usually there are common themes uniting the top performing groups, but we don't see one for this quarter. We note that REITs were the second best performing sector for all of 2021, possibly the result of rapidly rising rents across several submarkets. Technology was the fourth best performing group for the year. During the quarter it was led by big gains for Apple and Microsoft which together account for 38% of sector weight. Rounding out the top three sectors for the full year were energy and financials, both benefitting from the rebound in economic growth.

The worst performers during the fourth quarter were communication services, financials, and energy. The latter two are considered among the market's most economically sensitive groups, and concerns about more restrictive Fed policies and Omicron's impact on the economy likely hurt both as the fourth quarter progressed. Communications services was hurt by poor performance of Meta Platforms (formerly Facebook, 17% of sector value) and several stocks that saw weaker than expected growth as the economy reopened in the second half of 2021 (including Disney, Comcast, and Netflix). For the full year the worst performing sectors were communications services, utilities, and consumer staples.

Portfolio Positioning

We made no significant changes to fixed income allocations during the quarter. Risk/reward tradeoffs in fixed income continue to seem generally unfavorable to us. For most equity accounts, we reduced the allocation to international stocks. Proceeds from sales were mostly put into existing positions.

Over the past five years, international stocks (as measured by the MSCI ACWI ex U.S. index) returned 9.6% per year, significantly below the S&P 500's 18.5% annualized gains. Despite the recent record, there have been periods when international stocks have substantially outperformed the U.S. For example, over the ten-year period ended December 31, 2009, the MSCI Emerging Markets index posted an annualized return of 10.2% vs. negative 1.2% for the MSCI USA index[(3)]. We note that international stocks account for roughly 40% of total world stock market value.

International stocks have seemed attractive to us in recent years because: 1) non-U.S. developed markets usually have been less expensive than the U.S. and 2) developing markets often have had higher growth rates. We've thought that these positive factors would lead to good returns in foreign stocks. But during 2021, slower post-pandemic economic recoveries in Europe and Japan and substantially greater government regulation in China led us to rethink international exposure. We concluded that seemingly structurally lower growth in non-U.S. developed countries and the potential for additional regulation in developing markets may keep international stocks from catching up to the U.S. Accordingly, we believe lower exposure makes sense for now.

2022 stock market outlook. We believe that earnings growth and interest rates are the key issues for the market in 2022. Yardeni Research shows 2022 consensus earnings for the S&P 500 at $245[4], implying 8% growth and a somewhat above average stock market valuation at 19.5x 2022 estimated earnings. Among the factors that likely will impact earnings are whether:

- Exceptionally strong consumer spending in 2021 pulled forward spending that would have occurred in 2022
- Companies can maintain margins in the face of supply chain constraints (reportedly easing) and, more importantly, higher labor costs
- Interest rates rise enough to have a material impact on company borrowing costs
- Omicron and/or other Covid variants restrain economic activity

In our opinion, the combination of a pull forward in demand and higher labor costs will make 2022 consensus earnings expectations difficult to achieve. This will be especially true over the first half of 2022, when sales comparisons are hardest. 2022 also could be challenging to the extent there are waves of Covid infections – this could cause ebbs and flows in the economy just as the Delta variant impacted third quarter 2021 earnings growth.

At its most recent, December 15 meeting, the Fed indicated an accelerated wind down of its asset purchases and the likelihood of three interest rate increases in 2022. In our opinion, this more restrictive monetary policy will lead to higher market volatility for the year. But if the Fed succeeds in reducing inflation without significantly restraining growth, its actions could go a long way in supporting the market during 2022.

(1) From FRED (Federal Reserve Bank of St. Louis economic data), displaying ICE BofA US High Yield Index Option-Adjusted Spread data.
(2) Market sector performance numbers based on Vanguard sector ETFs' performance.
(3) Vanguard research publication, April 2010.
(4) Yardeni Research, Inc., December 27, 2021.

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