Market **Insights**

Economy | **Capital Markets**

Q4
2021

Economy

Winston Churchill famously said, "Success is the ability to go from one problem to another without losing enthusiasm." Too often, we let the steady drumbeat of negativity surrounding us dictate our thoughts, emotions and investment strategy. Today, the constant bombardment of depressing news about Covid, inflation, supply-chain issues, government deficits and partisan politics tends to overshadow many of the positive underlying fundamentals and trends in our economy.

The resiliency of the economy after an unprecedented pandemic-induced shutdown has been nothing short of remarkable. Both the manufacturing and service portions of the economy are above pre-pandemic levels. The nation's unemployment rate is close to where it was before the Covid outbreak. Wages are rising at their fastest pace in about 20 years. The household debt-to-income ratio is the lowest in at least 40 years. While our response to the pandemic is far from perfect, our collective efforts to preserve our economy and fight through many difficulties has been under-reported and perhaps not fully appreciated.

Over the past year, the economy has persevered and posted stellar growth numbers. The Gross Domestic Product (GDP) is expected to jump to a 6-7 percent annualized pace in the fourth quarter, after a more modest 2.1 percent reading in the third quarter. For the full year, growth is expected to come in around 5.5 percent and remain above its long-term average. Consumers, still flush with cash from the government assistance over the past year along with higher wages, remain the engine of economic growth. For instance, the latest data shows retail sales surged 6.6 percent in the third quarter as consumers purchased a wide variety of goods. However, with consumer inflation running hot at around 6 percent year-over-year, consumers will likely temper their enthusiasm in the quarters ahead. At the same time, manufacturers continue to struggle to keep pace with higher consumer demand while wrestling with supply-chain disruptions and higher input costs. Still, the manufacturing index recently jumped to a seven-month high with an acceleration in new orders and employment. The services sector, which represents the largest portion of the economy, reached an all-time high in November. All 18 services industries reported growth, with an uptick in employment and new orders. The rebound in economic activity has pushed the nation's unemployment rate down to 4.2 percent, close to where it was pre-pandemic. A general lack of workers has left many businesses struggling to fill open positions and has forced them to increase wages and offer other incentives to entice workers.

The combination of strong growth and an acceleration in consumer inflation has finally caught the attention of the Federal Reserve (Fed). Until recently, the Fed has indicated inflation was "transitory," expecting it to recede in the quarters ahead, while simultaneously keeping monetary policy extremely accommodative. In early December, the Fed changed their perspective on inflation and decided to accelerate the wind-down of their asset purchase program. The Fed also indicated the historically low level of interest rates will change over the next few years. It intends to modestly raise short-term interest rates to help quell accelerating inflation.

During the quarter, while investors were somewhat optimistic, they were reminded of the lingering risks in the economy, including: the new Omicron variant, rising inflation, uncertain monetary policy and elevated asset valuations. Still, corporate earnings growth remained strong. The S&P 500 posted a 40 percent increase in earnings over the past year. Although earnings are expected to moderate over the next few quarters, they should remain very healthy. For the quarter, the S&P 500 posted a healthy 11.02 percent return, while small- and mid-cap stock returns were more modest at 5.59 percent and 7.97 percent, respectively. Growth stocks tended to outperform value, and international stocks generally lagged domestic. In fixed-income, the yield on the 10-year U.S. Treasury bond remained a bit volatile and ended the quarter lower. Bond returns were slightly positive for the quarter.

Looking ahead, while the underlying economic foundation remains solid, several headwinds could hinder the recovery. First, the new Covid variant is wreaking havoc as it appears highly transmissible. Next, the Federal Reserve has announced a reduction in their balance sheet and a probable hike in interest rates in the quarters ahead. Finally, the government's massive stimulus programs, which included financial support to many consumers and businesses over the past 18 months, is ending soon. Still, amidst these headwinds, many positive trends persist in the economy, which should help offset some of these nagging issues. In this more uncertain environment, the capital markets have become more volatile as investors assess the risks and opportunities ahead. After healthy returns in stocks over the past few years, we expect more modest returns in the year ahead. In bonds, slightly higher interest rates could hurt high-quality bonds, while riskier bonds should hold up slightly better. We continue to work diligently to analyze the environment and make strategic investment moves in client accounts as appropriate.

As always, investing in capital markets comes with some risk and uncertainty. We thank you for your continued support of our investment process as we work hard to deliver positive risk-adjusted portfolio returns to our clients. Should you have any questions, please do not hesitate to reach out to your financial adviser.

Capital Markets

Although investors remained concerned about higher inflation and reduced support by the Federal Reserve, stocks pushed higher during the quarter. Elevated inflation hurt most areas of the bond market as returns were generally lackluster.

Disclosure: It is not possible to invest directly into an index. The indices listed above are unmanaged and are not affiliated with the Advance Capital Companies.

Market Index Performance (%)
As of Dec. 31, 2021

	4th QTR	YTD	1 Year	Annualized 3 Year
S&P 500	11.03%	28.71%	28.71%	26.07%
Dow Jones Industrial	7.87%	20.95%	20.95%	18.49%
Nasdaq Composite	8.45%	22.18%	22.18%	34.26%
Barclays Aggregate Bond	0.01%	-1.54%	-1.54%	4.79%
FTSE USBIG Corporate	-0.05%	-1.01%	-1.01%	7.62%
MSCI World	7.77%	21.82%	21.82%	21.70%

Economy from a Historical Perspective

	Latest	Average*	Definition	Comments
U.S. Unemployment Rate	4.20%	6.04%	**Represents the number of unemployed persons as a percent of the labor force**	Steadily declining
Consumer Price Index	6.88%	3.95%	**Represents changes in prices of all goods and services purchased for consumption**	Sharply higher
U.S. Capacity Utilization	76.83%	79.99%	**The greatest level of output that a plant can maintain within the framework of a realistic work schedule, accounting for normal downtime**	Low, but improving
Gross Domestic Product⁺	9.60%	6.35%	**Total value of all goods and services produced indicates strength or weakness of the economy**	Historicallly high
10 Year Treasury Yield	1.55%	6.08%	**Yield on the current 10 year treasury bond**	Historically low
Annual Housing Starts	1,679,000	1,428,562	**New privately owned housing unit starts annualized rate**	Trending higher

*Average from 1966 to Present ⁺ Annualized Source: Bloomberg

Disclosures: Investments are not insured, and may lose money. Client should be prepared to bear the risks associated with investing.

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