WebsterBank

2021 Review and 2022 Outlook: Happy New Year?

Stocks performed exceptionally well in 2021, despite the ongoing COVID-19 pandemic. Our investment themes for 2021 were largely on point and will evolve as we turn the page to 2022. We expect stocks to continue to benefit from a global economic reopening, while bonds struggle with rising interest rates and a vigilant Federal Reserve.

2021 Capital Markets Review

U.S. large cap stocks led the way in 2021, with the S&P 500 returning 28.7%, followed by U.S. small cap with a 14.8% return. International stocks continued to lag, with developed markets up 11.3% and emerging markets down 2.5%. Bonds broadly underperformed, with the aggregate bond market down 1.5%, despite strength in treasury inflation-protected bonds (TIPS) and corporate high yield at 6.0% and 5.3%, respectively.

Asset Class Returns

Asset Class	Benchmark	December 2021	Q4 2021	YTD 2021
U.S. Large Cap	S&P 500	4.5	11.0	28.7
U.S. Small Cap	Russell 2000	2.2	2.1	14.8
International Developed	MSCI EAFE	5.1	2.7	11.3
Emerging Markets	MSCI EM	1.9	-1.3	-2.5
U.S. Investment Grade	Barclays U.S. Aggregate Bond	-0.3	0.0	-1.5
U.S. Inflation-Indexed	Barclays U.S. TIPS	0.3	2.4	6.0
U.S. High Yield	BBgBarc U.S. Corp High Yield	1.9	0.7	5.3
EM U.S. $ Debt	JPM EMBI Global	1.4	-0.4	-1.8
Absolute Return	HFRX Global Hedge Fund	0.5	0.1	6.2

Source: Morningstar

A closer look at U.S. markets

Looking more closely at U.S. markets, four sectors (energy, real estate, financials, and technology) outperformed the broader market, as the chart below shows. While energy stocks led in 2021, performance was most likely a rebound of an oversold sector rather than a long-term bullish trend. As a result, we see oil pricing as vulnerable to increased supply over the coming months and remain bearish on the sector over the longer term. Our positioning in technology, real estate and financials helped drive strong performance during the year in client portfolios.

Sector Returns: Q4 and 2021

Sectors	Index	Q4 2021	2021
Energy	S&P 500 Sec/Energy	8.0	54.6
Real Estate	S&P 500 Sec/Real Estate	17.5	46.2
Financials	S&P 500 Sec/Financials	4.6	35.0
Info Technology	S&P 500 Sec/Information Technology	16.7	34.5
S&P 500	S&P 500	11.0	28.7
Materials	S&P 500 Sec/Materials	15.2	27.3
Health Care	S&P 500 Sec/Health Care	11.2	26.1
Consumer Disc	S&P 500 Sec/Cons Disc	12.8	24.4
Comm. Services	S&P 500 Sec/Commun Services	0.0	21.6
Industrials	S&P 500 Sec/Industrials	8.6	21.1
Consumer Staples	S&P 500 Sec/Cons Staples	13.3	18.6
Utilities	S&P 500 Sec/Utilities	12.9	17.7

Source: Morningstar

2021 Investment Themes Review

Each year, we attempt to identify the broad themes that will most heavily influence market behavior, and in turn, client portfolio returns. In 2021, we identified three themes that drove our asset allocation decisions and portfolio positioning. Below we review those themes and lay the foundation for investing in 2022 and beyond.

THEME 1: INNOVATION ACROSS SECTORS

In 2021, the pandemic was a true test of a company's ability to manage uncertainty. Some companies floundered, some stayed afloat, and others, whose business models were designed to adapt, flourished. Despite the geopolitical, economic, and pandemic-related headlines, individual companies that found innovative solutions to pandemic-related challenges led their respective industries and performed extremely well.

The following are some top performers in the S&P 500, Dow Jones Industrial Average, and Nasdaq 100 that fit well with our innovation theme (Source: FactSet):

- **Nvidia Corporation (up 125.5% in 2021)** is a leading semiconductor manufacturer that is positioned for the future of cloud computing and the next generation of connected devices.
- **Home Depot (up 59.5% in 2021)** reserved its own ships in 2021 to address supply chain issues and to keep shelves stocked.
- **Microsoft (up 52% in 2021)** continues to evolve its product offering for the next generation of computing.
- **Costco Wholesale Corporation (up 52% in 2021)** remained a leader in retail despite significant supply chain issues.
- **Paychex (up 50% in 2021)** continues to innovate its payroll and HR solutions to meet evolving client demand.

As we move into 2022, we will continue to explore the innovation theme, focusing on well-established companies that continue to optimize processes in order to retain or acquire a leadership position in their industries.

THEME 2: FOCUS ON CYCLICALS NOT VALUE

Coming into 2021, our second major theme was that we favored *cyclical* stocks but not necessarily *traditional value* stocks. While many may argue the two are synonymous, we would beg to differ. Cyclicality in 2021 meant those stocks that would disproportionately benefit most from the vaccine-driven economic reopening that took place throughout the year. Access to "cyclicality" can be found in nearly all sectors of the market from traditional technology (via semiconductor stocks like NVDA, for example), communication services (Alphabet, for example, which benefits from the "reopening" by increased ad spending) and health care (via medical device and diagnostics companies).

Cyclical stocks beat out value and growth issues

For the first five months of the year, value stocks maintained the outperformance that began in the fourth quarter of 2020. However, as the year progressed, the traditional "growth" sectors caught up and eventually passed the traditional "value" sectors, finishing the year up 27.6% versus 25.2% for U.S. large cap value (Source: Morningstar; Russell 1000 Growth / Value indices). Cyclical stocks exhibited less volatility through the "growth-to-value-to-growth" rotation and ended slightly above growth stocks for the full year, benefiting from the ongoing reopening of the global economy.

Relative Monthly Performance of Growth versus Value: January 2020 - December 2021

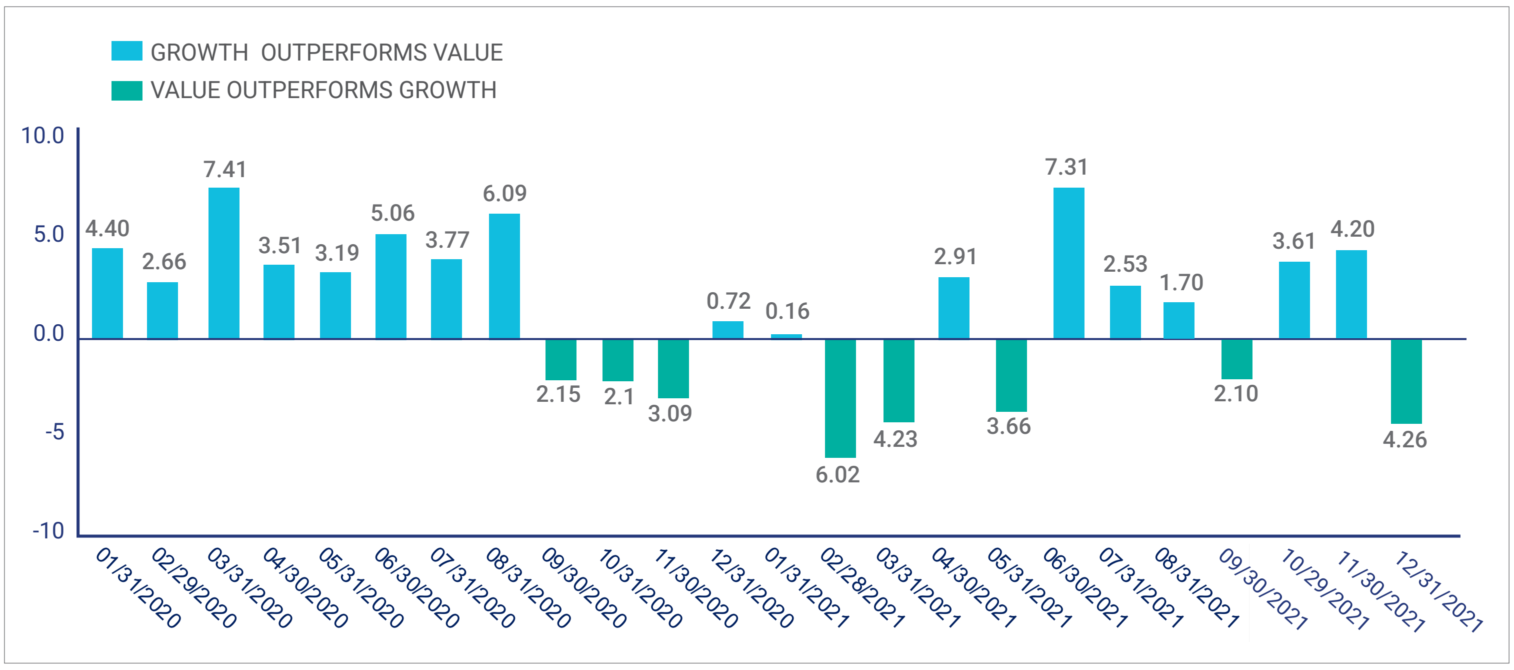
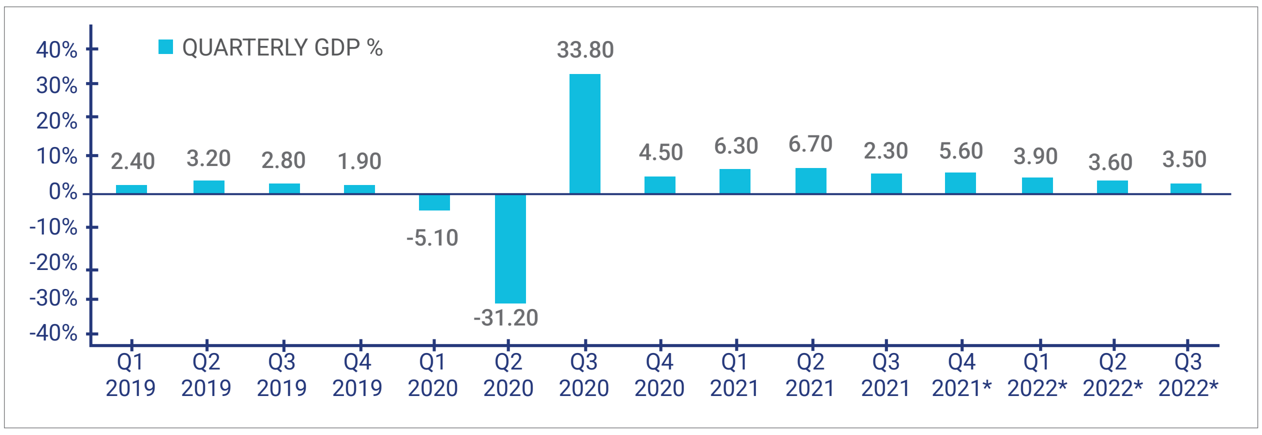


Chart represents Russell 1000 Growth monthly performance minus Russell 1000 Value monthly performance. Source: Morningstar

With 2022 GDP forecast to grow at 4% in 2022 (Source: FactSet), our themes of both "innovation" and "cyclicality" will evolve into an equity-oriented theme that incorporates both characteristics. We will discuss this in more detail on the pages that follow.

U.S. Real GDP Growth



Source: FactSet
*Estimated

THEME 3: ALTERNATIVES & FIXED INCOME

As confidence in the economic recovery grew throughout 2021 and interest rates rose, investors continued to rotate out of low yielding bonds. The Barclays Aggregate Bond index lost 1.54% in 2021. Our underweight and short duration positioning within fixed income helped total portfolio performance for the year.

Mitigating interest rate risk is key

Investment grade bonds are likely to face continued pressure in 2022 as the Fed accelerates the normalization of interest rates. We continue to believe our current fixed income and alternative strategy positioning is appropriate going into 2022 and anticipate additions to liquid alternative funds that exhibit low correlations to both equity and fixed income markets. In 2021, all the liquid alternative managers used in our client portfolios generated positive returns, despite a bond market that posted negative returns. We believe that mitigating interest rate risk (while avoiding increased equity exposure) in the year ahead will continue to be important as the U.S. Federal Reserve and other central banks begin to implement policies to normalize interest rates due to rising levels of inflation.

As we set our sights on 2022, we don't anticipate any drastic changes to client portfolios. We are well positioned currently for the dynamics that will drive market returns and poised to adapt to ever-changing economic conditions.

Here's a look at the themes that will drive portfolio management decisions this year.

2022 Themes

THEME 1: COVID SLOWS, ECONOMIC REOPENING ACCELERATES

It's hard to imagine a world without COVID. In addition to teaching many about the Greek alphabet, the omicron variant has demonstrated how viruses can evolve and become extremely infectious. We do not want to downplay the seriousness of this virus, but there have been many positive developments in the battle against COVID and we are seeing light at the end of the tunnel. If the experts are correct, the highly contagious omicron variant, with milder symptoms, quicker recovery time, and resulting immunity to COVID-19 and its variants, may be the beginning of the end of the pandemic. We're not in the business of forecasting pandemics, but this would certainly be a massive jolt for the global economy. As investors, it is now prudent to look beyond COVID and focus on fundamentals.

Growth despite higher-than-expected inflation

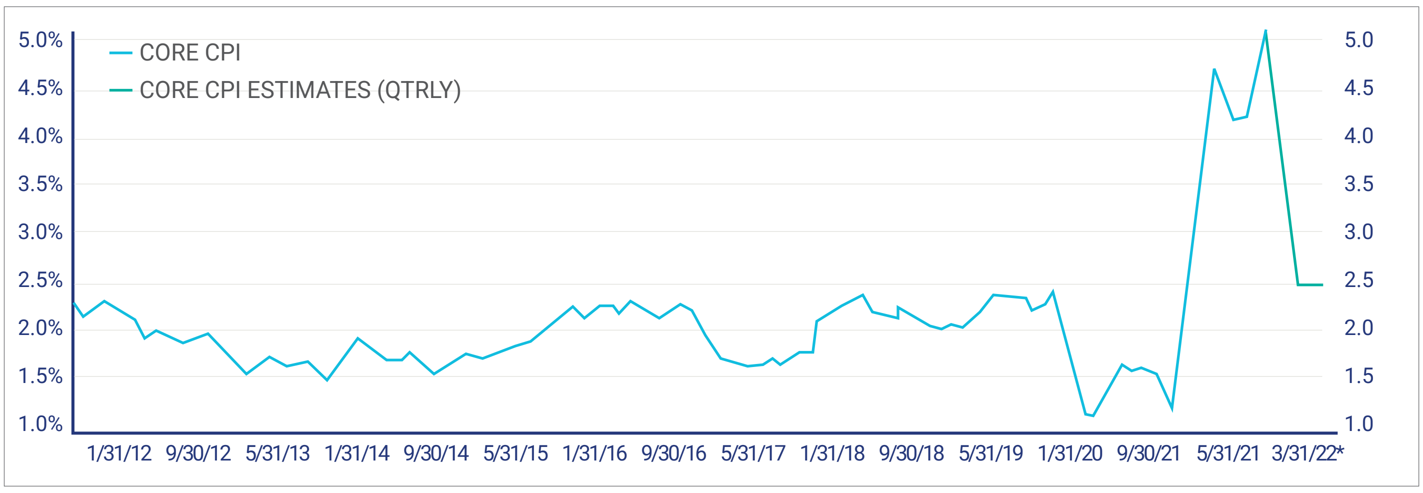
We expect earnings to grow at a rate above long-term averages in 2022. The Fed has begun tapering and will likely raise rates in 2022; however, the past two years of unprecedented stimulus has created sufficient tailwinds for global growth. The current environment remains supportive of rising global stock prices and GDP.

"Personal balance sheets remain strong and consumer demand for services will rise."

With rising employment and recovering supply chains, it is likely that business and consumer demand can offset the reduction in government spending and stimulus.

The economic recovery is not without risks and stimulus has side effects. It has become clear that current inflation is not transitory. Inflation will likely remain well above the Fed's long-term target of 2% in 2022 and perhaps beyond. The current full year forecast for Consumer Price Inflation (CPI) in 2022 is 4% according to FactSet.

U.S. Consumer Price Inflation



*Source: FactSet

"Diversification and risk management will remain crucial in 2022."

Wage growth will need to keep pace with inflation. Lower participation rates have been a big driver of the current low unemployment rate. It will be important to see how this impacts consumer demand. President Biden's Build Back Better plan is becoming less likely (but we believe this is largely priced into markets). Lastly, like the arrival of COVID, the unknown unknowns or black swans always pose a threat to investors.

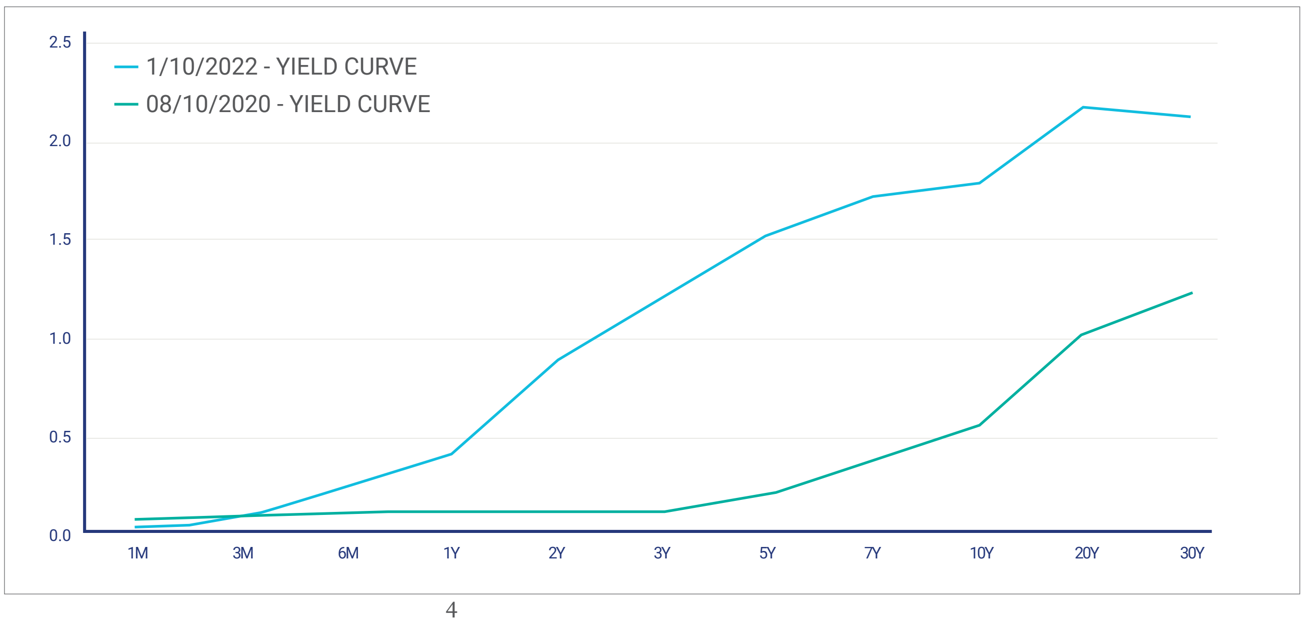
THEME 2: FED TAKES ACTION TO NORMALIZE RATE STRUCTURE

For the majority of 2021, Jerome Powell, Chair of the Federal Reserve, communicated to markets that increased levels of inflation being seen in the economy was not something to be concerned with as he and his colleagues on the FOMC (Federal Open Market Committee) believed elevated levels of inflation would be "transitory" in nature. Following months of the consumer price index (CPI) trending at levels higher than have been seen in the past 40 years, Fed Chair Powell has begrudgingly acknowledged inflation to be a stickier issue. As a result, Powell has indicated the Fed's updated plans to quickly wind down its quantitative easing program and possibly raise the federal funds overnight lending rate multiple times in 2022. These actions are designed to rein in inflation and should push the entire yield curve higher. The Federal Reserve's "Dot Plots" are pricing in three rate hikes in 2022. While we feel the equity markets could "digest" an orderly and expected rate-hiking cycle, deviations from the stated plan may cause bouts of volatility throughout the year.

Bonds remain near all-time lows

Investors typically own bonds for two reasons – income and/or downside risk protection. The chart below shows the recovery from August 10, 2020, the date that the 10-year Treasury bond retested the all-time low (green line). Despite significant recovery from pandemic lows, bond yields remain near all-time lows as of January 10, 2022 (blue line). As such, they fail to provide either significant income or downside protection against equity volatility. Additionally, interest rates across the yield curve are likely to continue to rise, and rising interest rates have a negative impact on current bond prices. The chart below shows the Treasury yield curve on January 10, 2022 and at "the bottom" on August 10, 2021.

United States Treasury Yield Curve



As a result, we continue to underweight bonds overall, while maintaining short duration in bond portfolios. Coupled with our liquid alternative funds, we continue to provide the appropriate blend of return and risk for clients, based on individual investment objectives.

THEME 3: EQUITIES CONTINUE TO LEAD

As the calendar turns to 2022, we believe equities will continue to lead. While we also expect positive absolute returns in 2022, we especially expect strong returns relative to bonds (which, as previously stated, should continue to struggle amidst a backdrop of rising interest rates).

The two most important factors for stocks in the long(er) term are the economic environment and the corporate earnings outlook. Both were extremely solid in 2021. What about 2022?

"Life is still nowhere near 'normal' and there is more economic reopening and pent-up demand yet to come."

While economic growth should moderate from 2021's torrid pace, 2022 GDP forecasts still have U.S. economic growth coming in at around 4.0% (per FactSet Consensus Estimates) and Europe looking even better at 4.1% (again, per FactSet). This is slower than 2021 but well above the long-term pre-pandemic trend. Omicron and other COVID-19 variants may delay this growth story–but not derail it–as there is no appetite for additional full-scale economic lockdowns.

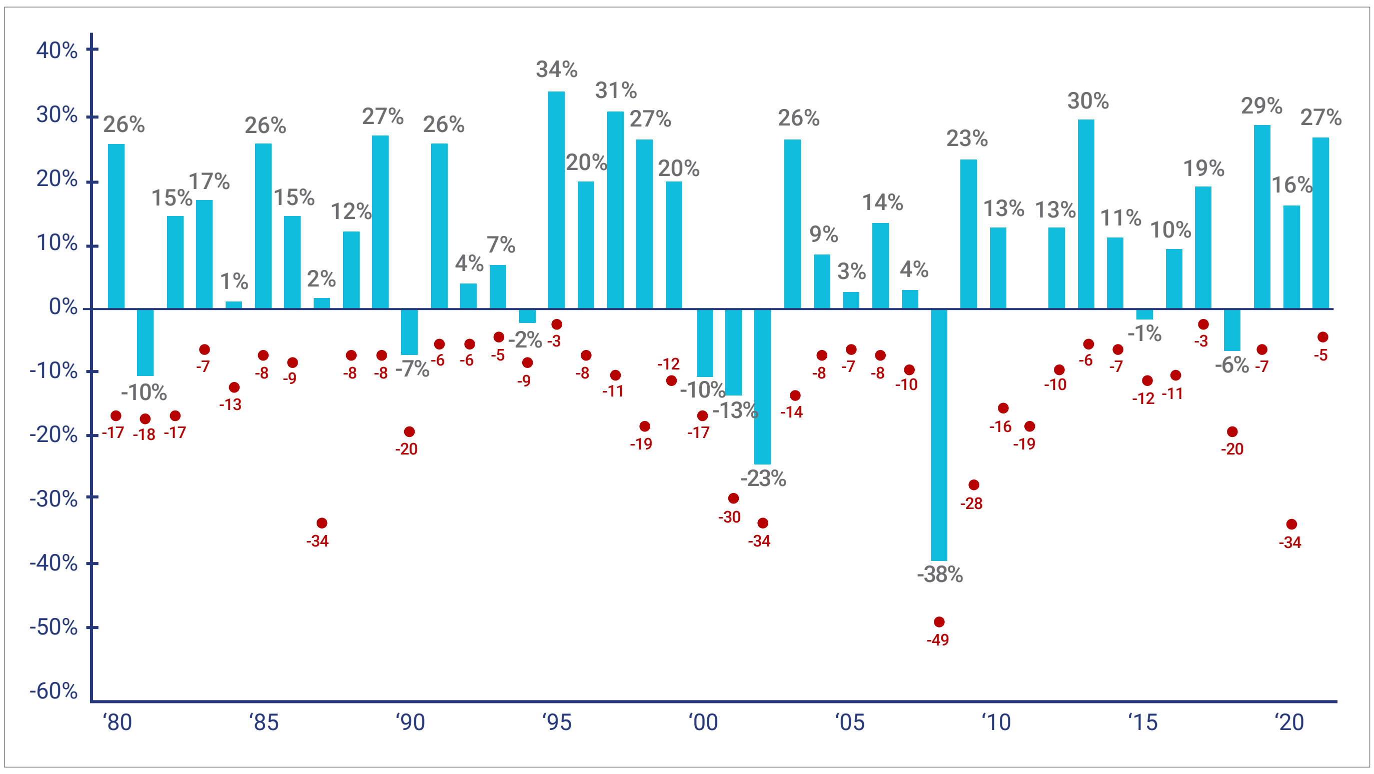
Similarly, corporate earnings should enjoy another good year in 2022. While U.S. companies are not expected to match 2021's extreme pace of +45% year over year earnings growth, current FactSet estimates are for +9.2% year over year earnings growth in 2022. To put this in perspective, the 10-year average is 5% (Source: FactSet). Companies across all industries have shown an amazing ability to adapt to challenges (supply chains, worker shortages and the like) during the pandemic and we expect that to continue. Strong earnings will be needed to push the market higher in 2022, but we think it can (and will) happen.

Risks to the Forecast

Of course, there are plenty of valid concerns for stocks right now and the financial media will be all too happy to remind of us of them. These concerns include continued high levels of inflation, new COVID-19 variants, and a plethora of geopolitical risks. It is highly likely that stocks will have a more volatile 2022 than 2021, when the largest peak to trough drawdown for the year was only 5% (source: J.P. Morgan, "Guide to the Markets," 12/31/21).

S&P intra-year decline vs. calendar year returns

Despite average intra-year drops of 14.0%, annual returns were positive in 32 of 42 years



Source: FactSet, Standard & Poor's, J.P. Morgan Asset Management.
Returns are based on price index only and do not include dividends. Intra-year drops refers to the largest market drops from a peak to a trough during the year. For illustrative purposes only. Returns shown are calendar year returns from 1980 to 2021, over which time period the average annual return was 9.4%.
Guide to the Markets – U.S. Data are as of December 31, 2021

Normal volatility

Remember that volatility is normal, and nothing to fear: Since 1920, the index has recorded a 5% pullback three times a year on average and a 10% correction once every year and a half. So, a more "normal" year in 2022 would not surprise us. For those of us who have extended experience in equity markets, every so often we have one of those gut-wrenching declines that makes us question why we ever put a nickel in the market. As the chart above shows, corrections (10%+ decline) and bear markets (20%+ decline) happen periodically.

Impact of COVID variants

Since 1980, we've had eight "bear market declines" of 20% or more. While we don't see that happening in 2022, a full-blown recurrence of COVID-19 would be the most likely reason for equity markets to give back the substantial returns since March 2020.

"While we aren't necessarily expecting 2022 to be as good as 2021, we still see a positive environment for stocks."

We clearly don't think this will happen, and we don't believe that it makes sense to "go to cash" in an attempt to avoid a significant correction at this time. A 10% correction may be likely at some point over the next 12 months, based purely on market history. Markets have largely ignored the potholes in the road to recovery. The delta and omicron variants have barely caused a ripple in equity markets. As a result, any deviations to expected growth and inflation readings in 2022 may be enough to spook equity markets. But, when we balance out the positive and negative factors for the year, we still come out on the positive side of the fence. An estimated $3.3 trillion of additional cash has been accumulated in bank accounts by American households since the beginning of the pandemic (Source: MFS Investments). Our guess is that more of that moves to equity markets than bond markets, with "real interest rates" (inflation adjusted) for bonds at 40-year lows and rate increases right around the corner.

As always, please don't hesitate to reach out to your contacts at Webster Private Bank if you have any questions. It is a pleasure to serve you during these difficult times and we appreciate the trust you have placed in us.