W A I N W R I G H T I N V E S T M E N T C O U N S E L , L L C

FINANCIAL MARKETS HIGHLIGHTS

Fourth Quarter 2021

What a year … what a quarter. For the equity markets, the fourth quarter was an extension of the last year, the last five years … even the last ten years. Mega-sized, US stocks did great. The S&P 500 gained +11.0% during the fourth quarter alone, wrapping up a +28.7% total return for 2021. Below the headline figure, though, results were more subdued. The Russell 2000 Index of small-cap US stocks returned +2.1% during the quarter (+14.8% for the year), international equities as proxied by the MSCI EAFE Index gained +2.7% (+11.3% for the year), and the MSCI Emerging Market Index declined -1.3% (-2.5% for the year).

For those of us that advocate the virtues of diversification, this phenomenon is, to borrow a phrase from CNBC commentator Jim Cramer, *sub-optimal*. Why own small-company stocks, value-oriented stocks, international and emerging market stocks, one may ask, when the S&P 500 of mega-sized companies continues to lead the way?

The answer is two-fold. First, market leadership any given year tends to be unpredictable, despite its remarkable consistency these last few years. Take emerging market equities, for example, which ten years ago were the *Belle of the Ball*, having outperformed the S&P 500 by ~10% per annum for the ten years ended December 2011. Fast forward to the present day and emerging market equities were down last year and have underperformed the S&P 500 by ~11% for the trailing ten years. Another example is small-company, value-oriented stocks which have been, over the fullness of time, one of the highest returning sectors of the market. Not so these last five years, as they have trailed the S&P 500 by ~9% per annum. Go back to *Tech Wreck* of 2000 through 2002, though, and the Russell 2000 Value Index of small-cap stocks *gained* +7.5% per annum, while the S&P 500 fell -14.6% per year.

It is a truism that relative returns are cyclical. Outperformance follows underperformance, and so on, but the timing of these changes is impossible to predict. The market tends to inflict maximum pain on those who attempt to "chase" returns, or avoid seemingly sleepy or dormant assets. One avoids that outcome by maintaining a diversified portfolio, across multiple asset classes.

Second, six technology behemoths now constitute one-quarter of the S&P 500 Index, an index that many investors believe represents the *broad* US stock market. Those six companies, Apple, Microsoft, Amazon, Tesla, Alphabet and Meta Platforms (formerly Facebook) continue to drive the index higher, because of their growth, but from a valuation standpoint they are expensive stocks and not without risk. Even excluding the incredibly expensive Tesla, this group trades at about a 90% premium to the average, equally weighted S&P 500 stock.

It is also worth noting that higher valued, growth-oriented stocks are more sensitive to rising interest rates than are their more staid value counterparts … and interest rates *are* beginning to rise, though it is early days. This greater sensitivity is because in a low or negative real interest rate environment (*i.e.,* inflation adjusted), as exists now, opportunity cost is low, or nil. If one earns 0% at their bank, he or she might very well be willing to buy a company, we will call it Growth Gadget, Inc., that is not profitable now, but has the allure of big *future* profits. Suppose one could earn 5% at the bank, though. Investing in Growth Gadget, Inc. would result in forgoing that known and current return for an unknown future return. There are many investors, if given the choice, who would choose certainty, and that reduces the demand, and therefore the value, of Growth Gadget, Inc.

Interest rates are rising because US Federal Reserve policy makers have found themselves in a pickle. After repeatedly referring to rising consumer prices as "*transitory*," officials and Fed Chair Jerome Powell had to admit that the cat was out of the bag, citing "elevated levels of inflation" in their December meeting press release. Only a few days prior the US Bureau of Labor Statistics released November Consumer Price Index data, reporting +6.8% price appreciation. Highlights (or lowlights) were a +59% rise in

Selected Index Returns (%) as of December 31, 2021 (Source: Morningstar Direct). 3, 5, 10 year returns are annualized.

	Oct.	Nov.	Dec.	QTR	YTD	1 Year	3 Year	5 Year	10 Year
S&P 500	7.01	-0.69	4.48	11.03	28.71	28.71	26.06	18.48	16.55
S&P 400	5.89	-2.94	5.08	8.00	24.76	24.76	21.41	13.09	14.20
Russell 2000	4.25	-4.17	2.23	2.14	14.82	14.82	20.02	12.02	13.23
Wilshire U.S. REIT Index	7.95	-0.29	8.82	17.14	46.18	46.18	19.19	10.92	11.47
MSCI EAFE	2.46	-4.65	5.12	2.69	11.26	11.26	13.54	9.55	8.03
MSCI Emerging Markets	0.99	-4.08	1.88	-1.31	-2.54	-2.54	10.94	9.88	5.49
Barclays Aggregate Bond	-0.03	0.30	-0.26	0.01	-1.54	-1.54	4.79	3.57	2.90
Barclays High Yield	-0.17	-0.97	1.87	0.71	5.28	5.28	8.83	6.30	6.83

fuel oil costs, +31% rise in used auto prices, +7% increase in electricity costs, and so forth.

The Federal Reserve's planned policy response is two-fold. First, it is reducing the pace of its massive Treasury Bond and Mortgage Back Security Bond purchases (so called Quantitative Easing). Second, it signaled its intent to raise the short-term Fed Funds rate several times in 2022. The Fed Funds rate is the short-term lending rate between commercial banks, and it is a foundational interest rate off of which many others are pegged. Both measures are intended to induce savings, thus marginally reduce demand for goods and services, and therefore reduce price pressure.

The US 10 Year Treasury began and ended the quarter at a 1.52% yield, but as of this writing (January 5th) the 10 Year Treasury is yielding 1.71%. The Bloomberg Barclays Aggregate Bond Index was flat for the quarter, but is down ~1% only a few business days into 2022, as interest rates tick higher.

On the commodity front, oil was little changed during the quarter while gold rallied +5.2%. Interestingly, Bitcoin was up almost precisely the same amount. The dollar rallied modestly against the euro and yen. On the dangerous topic of politics, we will only note that the likelihood of higher corporate and personal tax rates have diminished dramatically, and continue to do so with every passing day.

From the Wainwright Family to yours, wishing you a happy, healthy, and prosperous 2022.

Selected Index Returns (%) as of December 31, 2021 (Source: Morningstar Direct). 3, 5, 10 year returns are annualized.

	Oct.	Nov.	Dec.	QTR	YTD	1 Year	3 Year	5 Year	10 Year
S&P 500	7.01	-0.69	4.48	11.03	28.71	28.71	26.06	18.48	16.55
S&P 400	5.89	-2.94	5.08	8.00	24.76	24.76	21.41	13.09	14.20
Russell 2000	4.25	-4.17	2.23	2.14	14.82	14.82	20.02	12.02	13.23
Wilshire U.S. REIT Index	7.95	-0.29	8.82	17.14	46.18	46.18	19.19	10.92	11.47
MSCI EAFE	2.46	-4.65	5.12	2.69	11.26	11.26	13.54	9.55	8.03
MSCI Emerging Markets	0.99	-4.08	1.88	-1.31	-2.54	-2.54	10.94	9.88	5.49
Barclays Aggregate Bond	-0.03	0.30	-0.26	0.01	-1.54	-1.54	4.79	3.57	2.90
Barclays High Yield	-0.17	-0.97	1.87	0.71	5.28	5.28	8.83	6.30	6.83