HANLON
INVESTMENT MANAGEMENT

QUARTERLY REPORT — DECEMBER 31, 2021

2021 4th Quarter Review

Economic Commentary

The US Federal Reserve ("the Fed") finally faced its day of reckoning in dealing with inflation; first dropping the "transitory" label, then offering a roadmap for tapering monthly bond purchases and, eventually, raising benchmark interest rates. During the December Fed policy meeting, the Fed announced it would begin 2022 by reducing monthly bond purchases to $60 billion, half of what it was buying in November. If all goes according to plan, the Fed will cease purchasing any bonds by March. Phase two will be the gradual raising of interest rates, which have been pegged at 0%-0.25% since the COVID-19 pandemic prompted aggressive Fed action in early 2020. The Fed "dot plot" interest rate forecast, a closely watched but historically unreliable predictor, now reflects two or three rate hikes for 2022.

Figure 1: Changes in Federal Open Market Committee Target Rate Expectations from September to December Meetings

Federal Open Market Committee 2022 Year-End Target
Rate Expectations - September vs December

Number of FOMC Members
12
10
8
6
4
2
0
0%-0.25%
0.25%-0.5%
0.5%-0.75%
0.75%-1.0%
1.0%-1.25%
September FOMC Members
December FOMC Members

Data Source: US Federal Reserve. Chart by Hanlon Research.

Fed President Jerome Powell's tenure has been notable in its transparency, so the market was expecting the move and therefore able to digest the announced policy shift without a dramatic bond market tantrum, unlike prior Fed tightening announcements. Of course, the Fed had little choice but to address inflation, as recent US inflation has been persistently high, and one does not need a degree in economics to observe the implications on daily life with prices increasing and buying power eroding. The Fed's preferred measure of inflation, the Personal Consumption Expenditures Index, rose at an annual rate of 5.7% in November, the highest reading since September 1983. For reference, the Fed's target level for inflation is at or just below 2%. It's easy to see how we got here, with the unprecedented COVID-19 shutdown of global supply chains. By halting manufacturing, retail and service industries, the supply of goods and services was greatly diminished. Meanwhile, many US households emerged from the initial shutdown with stronger balance sheets as the result of decreased discretionary spending, government stimulus payments, residential real estate and stock investment appreciation, and continued mortgage amortization for those that have not participated in a new real estate transaction. This led to a reopening demand surge and a logistical nightmare for manufacturers and shippers.

Things get interesting when we look at how inflation impacts consumer behavior. On the one hand, higher current inflation decreases spending, at least discretionary spending. As Consumer Staples increase in price, buyers are less likely to splurge on Consumer Discretionary goods and services. Logically, we would expect supply and demand to reach equilibrium and inflation to ease over time. We also need to consider, however, the impact of *future expectations* of inflation. If consumers expect inflation to continue to snowball, they may accelerate planned purchases to now, under the premise that waiting will cost more later. This creates a self-fulfilling inflationary feedback loop, something the Fed is trying to reign in before it is too late.

Market Commentary

US equity Markets surged to start the quarter, with the S&P 500 advancing 7% in October. The momentum stalled in November and early December, but much of the weakness may have been attributable to year-end tax loss selling as investors trimmed laggards from their portfolios. Market breadth supports this notion, as a concentrated group of household-name mega cap stocks such as Apple (AAPL), Microsoft (MSFT), Netflix (NFLX), and Nvidia (NVDA) has been responsible for much of the recent index returns while other, lesser-known stocks have sold off considerably. The story of 2021 could be viewed as "US Large Caps vs the world" – with the US Large Caps trouncing the competition.

The final tally for 2021 shows the S&P 500 up 28.7% while US Small Caps, measured by the Russell 2000 Index, gained less than half of that at 13.7%. Developed International Large Caps also lagged the US, gaining 11.5%, and Emerging Market equities returned a relatively abysmal -3.6% (as measured by the iShares MSCI EAFE ETF, EFA and the iShares MSCI Emerging Markets ETF, EEM). It is a nearly universally accepted truth in investing that diversification is always wise, however the absolute dominance of US Large Caps has been hard to ignore. Over the past decade, US Large Caps have returned roughly double their Developed Market peers, at a 10 year-annualized rate of 16.5% for the S&P 500 vs 7.9% for the EFA ETF.

The dominance of US tech has been the biggest driver of the outperformance, as the US remains the epicenter of technology and innovation. European stocks, on the other hand, can be broadly viewed as value plays, with lower earnings multiples and higher dividend yields but less attractive growth profiles. Meanwhile, Emerging Markets have failed to deliver on their promising dreams of industrialization and free markets, with China seemingly moving backwards this year by imposing draconian measures against Chinese

companies that are seeking broader exposure to the outside world. With bond yields near zero, a lack of foreign innovation, and unpredictable Emerging Market regimes, US Large Caps have become the new de-facto “safe haven” investment.

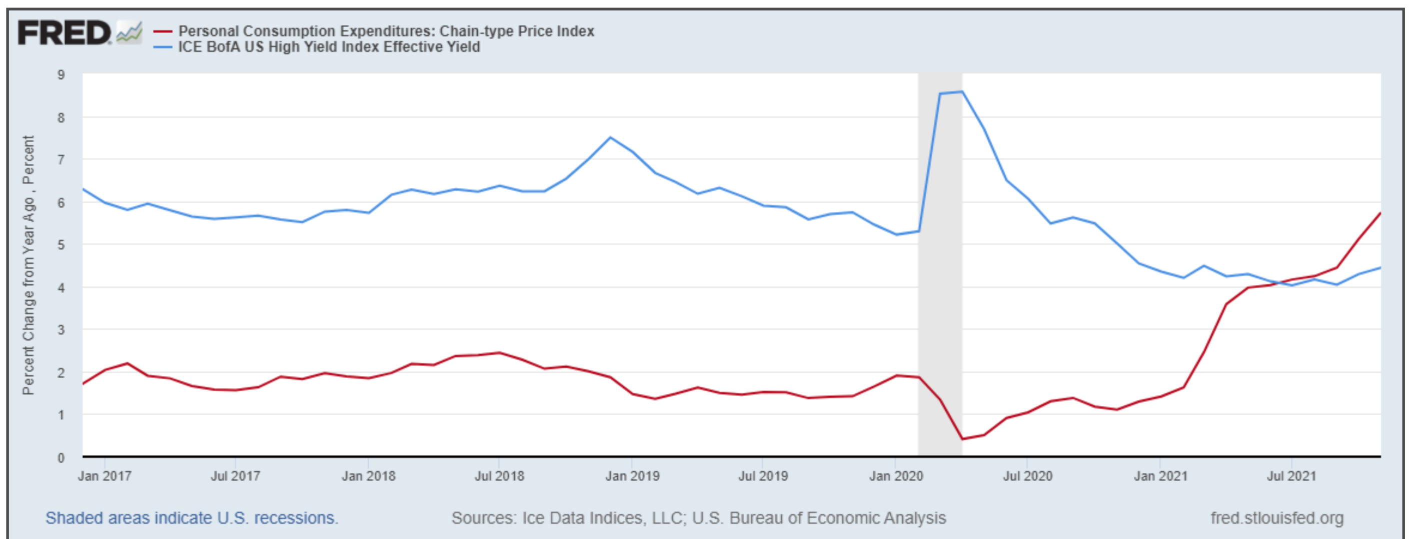
For fixed income markets, the initial reaction – or in this case, lack of a reaction – to the Fed’s 2022 proposed tapering and rate hikes can be viewed as a positive sign. Careful not to rattle markets, the Fed was measured in its approach. History shows that rising rate environments do not necessarily lead to stock market underperformance, and gradually rising rates can coexist with bull markets for equities. Rather, stocks tend to suffer when rates spike higher abruptly. As the Fed embarks on its tightening campaign, continued transparency and predictability will be crucial.

The 10-Year US Treasury Note Yield began the quarter at 1.52% and ended the quarter at 1.50%, as any upward interest rate pressure from the pending Fed tightening was offset by increased safe-haven demand stemming from the new omicron COVID-19 variant. Rates have struggled to rise much higher than this 1.5% level for most of the year, and while they should trend upwards gradually given the Fed’s policy shift, there will be persistent downward pressure on US Treasury yields due to demand from buyers, especially foreign. The Fed’s European counterpart, the European Central Bank (ECB), has maintained a 0% benchmark refinancing rate and has not signaled any intention to raise the rate until 2023.

US corporations seized upon the ultra-low interest rates by borrowing over $1.8 trillion in 2021, with roughly $500 billion of that number coming from high yield borrowers and the remainder being investment grade. Investment grade bonds, with lower yields and higher interest rate sensitivity (duration), had negative returns for the year at -1.8%, as measured by the iShares iBoxx Investment Grade ETF (LQD). High yield bonds fared better, with the iShares iBoxx US High Yield ETF (HYG) up 3.8% in 2021.

High yield investors face a bit of a conundrum heading into 2022 as they assess the risk/reward tradeoff of investing in speculative-grade debt. On one hand, the trailing twelve-month default rate is hovering around 2% and not expected to rise significantly in the coming year, with high yield borrowers’ balance sheets looking healthy and borrowing costs at historic lows. Another COVID-related shutdown looks unlikely despite the omicron surge; and considering that the Fed bailed out the high yield bond market during the initial shutdown, one could argue that high yield is relatively COVID-proof. The downside to this low credit risk environment is that spreads are reflecting the rosy outlook and yielding just 3% over Treasuries, for an effective yield of 4.3%. Considering that even high yield bond investors are now losing money to inflation, high yield may look a bit expensive presently.

Figure 2. High Yield Bonds Fail to Keep Up with Inflation



Data Source: St. Louis Federal Reserve.

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Closing Remarks

The final quarter of 2021 brought a little bit of choppiness but closed out in strong fashion with major domestic indices around new all-time highs. As the world weathers the omicron variant and the surge of record COVID infections, there is reason for optimism as the variant seems to be causing less-severe infections amidst rising vaccination rates. The biggest risks on the table appear to be the Fed's ability to tame the inflation monster and the market's reaction as we shift into a rising rate regime. Markets are discounting mechanisms, meaning the see the future and price it in today, and based upon the still-low level of interest rates the market is saying that the recent inflation increases will not be long lived. We expect to see negative values in upcoming inflation reports within 18 months or so.

Opportunities will present themselves in the coming year as we assess the market's reaction to the Fed policy shift. In the past, Growth-sector investments such as Technology stocks were vulnerable to rising rates, however this narrative may no longer hold true, considering the biggest of the Tech stocks are flush with cash and able to tap debt markets at lower rates than even many foreign nations can. A flexible approach to asset allocation will be crucial as we evaluate the ability of US Large Caps to weather the rising rate environment, as the relative outperformance could diminish in 2022 and beyond, advocating for a well-diversified portfolio.

The new year brings excitement and opportunity, and we look forward to helping you achieve your investment goals. As always, we will be guided by our principles of Passion, Integrity, Vision, and Care. Thank you for the opportunity to be of service and we hope that everyone stays healthy and positive in these trying times.

Sincerely,

Sean Hanlon, CFP®
CEO and Co-Chief Investment Officer

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