Fourth Quarter 2021 – Investment Commentary

WEST SHORE BANK

The U.S. economy is forecasted to grow +5.5% in fourth-quarter 2021, which is up from third-quarter 2021 growth of +2.3% but lower than the +6.5% pace in the first half of the year. For full-year 2021, consensus estimates call for economic growth of +5.6%. At the start of the year when vaccine rollouts began, the U.S. economy was slated to grow in the +8-9% range. While consumer and business demand remained strong throughout the year, it was tempered by persistent supply chain challenges and labor shortages. With regard to stock markets, what wasn't tempered was the optimism surrounding the vaccine rollout.

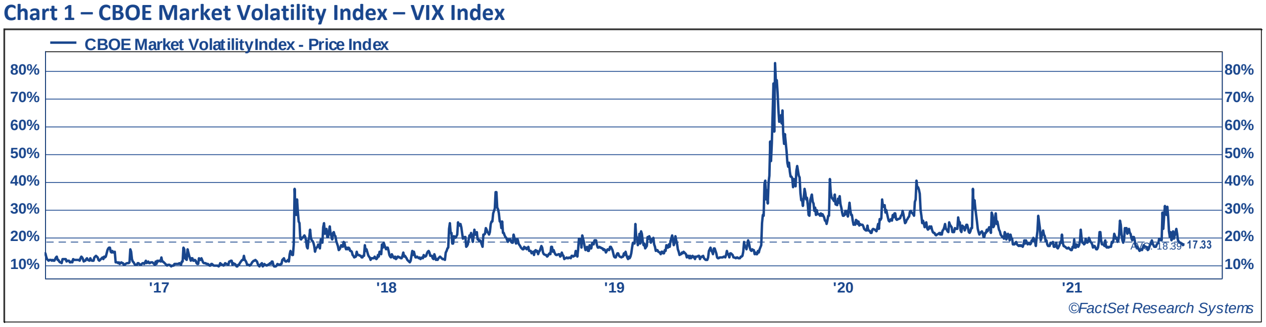
For most of last year, the path of least resistance for stock markets was to the upside. It didn't matter what the concern or bad news was, stock markets trended higher. Even the emergence of the Omicron COVID variant last quarter did not diminish stock market enthusiasm, nor did the highest consumer inflation rate since 1982. Stocks finished the quarter, and the year, on a high note with the S&P 500 marking numerous all-time closing highs. All told, the S&P 500 set 70 all-time closing highs in 2021.

Table 1 – Stock Index Returns as of December 31, 2021

Equity	1-Month	3-Month	YTD	1-Year	3-Year	5-Year	10-Year
S&P 500	4.48	11.03	28.71	28.71	26.07	18.47	16.55
S&P 400	5.08	8.00	24.76	24.76	21.41	13.09	14.20
NASDAQ	0.74	8.45	22.18	22.18	34.26	24.97	20.96
Dow Jones Industrial	5.53	7.87	20.95	20.95	18.49	15.51	14.21
Russell 2000	2.23	2.14	14.82	14.82	20.02	12.02	13.23
MSCI Developed	5.12	2.69	11.26	11.26	13.54	9.55	8.03
MSCI Emerging	1.88	-1.31	-2.54	-2.54	10.94	9.87	5.49

Stock market returns were propelled higher by robust revenue and earnings growth. For 2021, S&P 500 revenue and earnings growth are estimated to finish at +15.8% and +45.1% respectively. Earnings growth estimates for 2022, while positive, have been moving lower the past few months on worries about inflation, COVID and Federal Reserve monetary policy. In our last quarterly commentary, we postulated that the fourth quarter would be a volatile one for stock markets and it was, especially in November.

Chart 1 – CBOE Market Volatility Index – VIX Index



The VIX Index rose to its highest level since January 2021 pushing the small-cap Russell 2000 Index into correction territory and fostered a rotation out of growth and cyclical sectors and into defensive sectors in December. Small businesses are having a tougher time dealing with COVID mandates, inflation pressures, and labor shortages than larger companies. Total returns shown in Table 1 above bear this out as the small-cap Russell 2000 Index underperformed large-cap indices, the Dow Jones Industrial Index and the S&P 500 Index, on a 1-month, 3-Month, YTD and 1-Year basis.

We also surmised in last quarter's commentary that, "due to the lack of any comparable precedent and the extensive complexity of how people and businesses may respond to COVID related restrictions, mandates, and policies, the uncertainty encompassing COVID remains a primary risk". Uncertainty encompassing COVID means not only the mutations but also the ancillary effects of policies on supply and demand imbalances, inflation, the labor market, and the overall economy. The recent unexpected rise of the Omicron (sounds like a Transformer character) variant serves as the perfect “primary risk” example.

Over the past two years, there has been a kaleidoscope of opinions and responses on how to effectively deal with COVID. With the Omicron variant, some government authorities are issuing another round of mandates and restrictions while other government officials are taking the opposite approach and letting individuals decide for themselves the level of risk they wish to take. At the globe level, several foreign nations have reinstituted lockdowns, which thankfully has not been the case in the U.S. as most people already are suffering greatly from COVID lassitude. The inconsistency of approach and messaging heightens uncertainty.

Further lockdowns, vaccine mandates and restrictions will exacerbate the supply chain crisis and prolong higher inflation rates. The supply chain side of things is still in disarray making it difficult for businesses to keep up with strong demand. There continue to be widespread shortages of labor, raw materials, parts, shipping, and transportation which is keeping upward pressure on inflation. Last November’s twelve-month inflation rate reached its highest level since June 1982 at +6.8%. Even the Federal Reserve recently capitulated that higher inflation was, indeed, not transitory. This inflation revelation has accelerated their start date for raising short-term rates.

The general consensus is that the Federal Reserve will raise rates three times in 2022 with the first-rate hike coming this March. In anticipation of the Fed rate hikes, last quarter the yield curve flatted with the short-end of treasury yield curve rising sharply and the longer-end of the yield curve falling modestly. Overall for 2021, yields rose with the 2-Year Treasury bond rising from +0.12% to +0.73% and the 10-Year Treasury bond rising from +0.92% to 1.51%.

Table 2 – Fixed Income Index Total Returns – as of December 31, 2021

Fixed Income	1-Month	3-Month	YTD	1-Year	3-Year	5-Year	10-Year
Barclays High Yield	1.87	0.71	5.28	5.28	8.83	6.30	6.83
Barclays Municipal	0.16	0.72	1.52	1.52	4.73	4.17	3.72
Barclays Inter Gov't/Credit	-0.13	-0.57	-1.44	-1.44	3.86	2.91	2.38
Barclays Aggregate	-0.26	0.01	-1.54	-1.54	4.79	3.57	2.90

The U.S. economy should post solid growth again in 2022 as household wealth and business balance sheets are in good shape which should keep demand strong and earnings positive. The main risks to growth are COVID and related policies, Fed policy, inflation and rising geopolitical risks. A return to normalcy with COVID would go a long way in solving many economic related issues but the likelihood of this is low. Remember fifteen days to flatten the curve? The Fed is likely going to be measured in raising rates unless forced to by accelerating inflation. They have a difficult policy dilemma in trying to reduce stimulus/inflation while not pushing the economy into recession. The bond market seems more concerned about economic growth than inflation. For 2022, we continue to employ a cautiously optimistic tactical approach for stocks and bonds.

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Sources: FactSet, The Federal Reserve, U.S. Department of Labor, U.S. Bureau of Economic Analysis