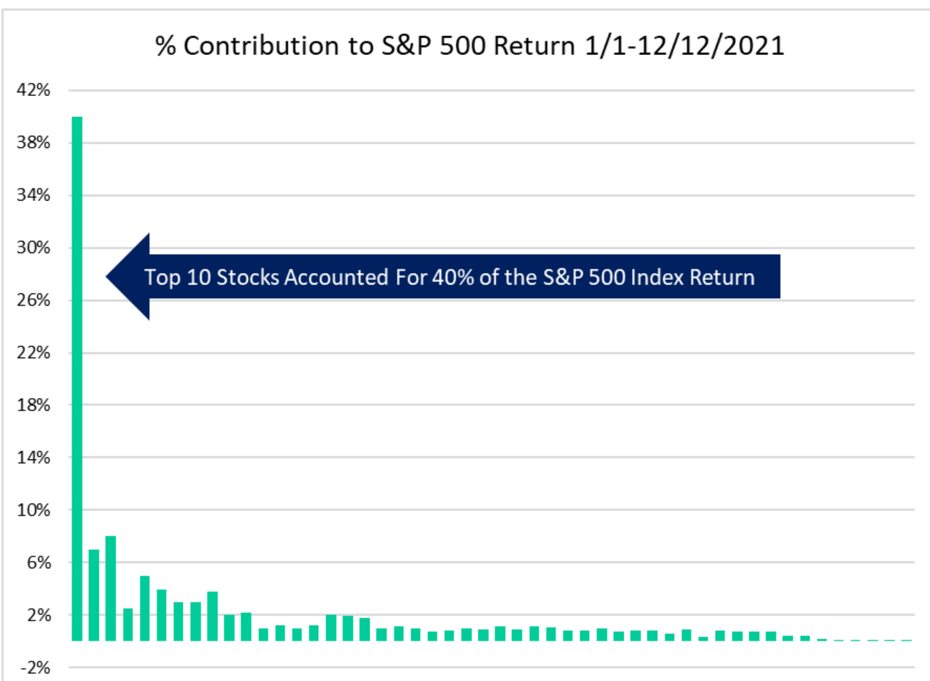
Market Perspectives of Waypoint Advisors **Fourth Quarter 2021**

The economy is steaming ahead and equity markets are betting on more

On the economic front, estimates for US real (after subtracting inflation) GDP growth in Q4 2021 range from 4.3% to 7.0% according to the Federal Reserve Bank of Atlanta.[1] The World Bank also predicts strong growth internationally, with the Euro area forecasted at 5.2% and emerging markets at 6.3%.[2] U.S. equity markets had a strong quarter with the S&P 500 index returning more than 11%.[3] International equities had much weaker sub 5% returns for the quarter and emerging markets returns were negative, driven by concern about the changes occurring in China.[4]

Three years of double-digit returns in US equities. What's next?

Three consecutive years of double-digit US equity returns during a global pandemic and 70 all-time highs of the S&P 500 index in 2021[5] make investors eager for more! We have seen unprecedented fiscal stimulus that allowed lower income workers to weather unemployment and increase their savings and spending. Meanwhile, the Fed, by keeping rates low, has enabled those who have financial assets to prosper. Spending was fueled by pent-up demand as the economy began to open and was exacerbated as well by more people wanting to work from home or perhaps just



Data Source: Koyfin.com

finding their homes too small with everyone stuck at home. This propelled our equity markets and created $40 trillion

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[1] https://www.atlantafed.org/-/media/documents/cqer/researchcq/gdpnow/RealGDPTrackingSlides.pdf
[2] https://www.worldbank.org/en/news/press-release/2022/01/11/global-recovery-economics-debt-commodity-inequality
[3] Source: Morningstar.
[4] Source: Morningstar. International equities represented by the MSCI EAFE index and emerging market returns represented by the MSCI EM index.
[5] Source: https://www.usnews.com/news/business/articles/2021-12-31/asian-shares-mixed-in-scant-new-year-eve-trading

in wealth,[6] a record level despite extremely high unemployment. Thus, we have seen record corporate profit margins despite COVID. These boons have served investors well but have created unusual market dynamics that are causes for concern. For example, the 10 largest companies in the S&P 500 index (weighted by their market cap) accounted for 40% of its return from 1/1-12/12/2021 as shown in the chart below.[7] Their projected 12 month average P/E ratio is 33.2 times versus 19.7 for the remaining companies in the index.[8] The largest and most expensive stocks outperformed the remainder of the index but the question is, can these 10 behemoths continue to grow earnings at a pace that will justify a P/E ratio 69% higher than the average of the 490 smaller companies in the index?

We do not know, but we see an environment where the effects of the stimuli that have sustained our equity markets are fading and with no expectation of additional fiscal support, investors' concerns are now focused on inflation and the Federal Reserve's next moves.

What about the risk of inflation?

With the most recent unemployment rate coming in at 3.9%, it is clear that the Fed has met its mandate of full employment and is now facing the much harder challenge of managing inflation. The current inflationary trends are driven partly by pent-up demand and changing housing desires. This demand contributes to supply problems. However, in many respects, current inflation is primarily due to a COVID crippled supply chain and a lack of workers, which the Fed has little ability to control. Wages are up 6.0%,[9] rental housing costs over 17%,[10] median home prices 14%[11] and the cost of transportation 26%.[12] In addition, oil prices have risen 59%[13] over the past year as US oil producers have not responded as quickly to increasing prices as they have in the past; thus, exacerbating the current undersupply of oil. The hope is that this inflation will be transitory as COVID subsides.

Markets are taking Omicron in stride

While the Omicron variant of COVID has caused remarkable spikes in the number of COVID cases globally, recent data suggests that its mortality rate is similar to or lower than previous variants. Markets have reacted in a manner similar to previous waves of COVID by initially exhibiting heightened volatility and rotating into stocks that are COVID beneficiaries, but investors seem to understand the dynamics of COVID shocks much better and are currently more concerned with inflation than with the drag that Omicron will have on economies. The biggest worry about Omicron is not so much that it will cause serious illness, but that it will cause more workers to be ill and create an even greater labor shortage, further worsening supply chain bottlenecks.[14]

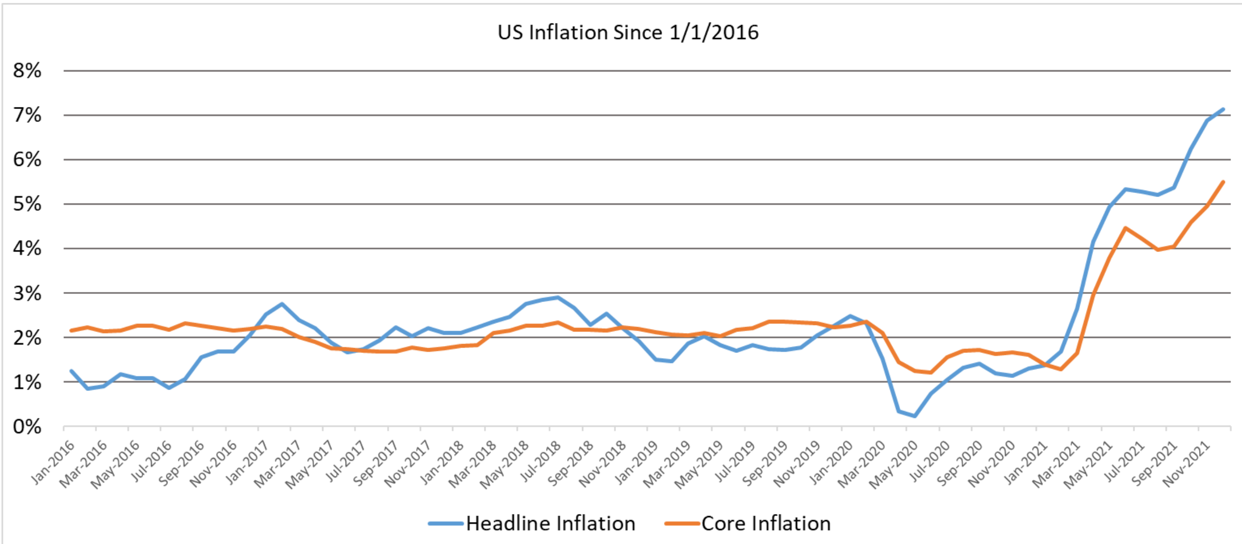
All eyes are on the Federal Reserve

The Fed's tools are limited in their ability to combat inflation. It can increase the cost of borrowing for consumers by raising the Fed funds rate which in normal circumstances should reduce consumer demand. However, many consumers are flush with savings due to stimulus monies so borrowing costs are not as much of a consideration in spending decisions. Additionally, our current inflationary environment is not being driven by too much demand as by too little supply as exemplified by the spike in automobile costs due to the shortage of computer chips used in their

[6] Source: JP Morgan Guide to the Markets, 12/31/2021.
[7] Source: Investing.com, https://www.investing.com/analysis/narrowing-leadership-fewer-stocks-contributing-to-broader-market-200611434
[8] Source: JP Morgan Guide to the Markets, 12/31/2021.
[9] Federal Reserve Bank of Atlanta, Wage Growth Tracker, https://www.atlantafed.org/chcs/wage-growth-tracker?panel=3
[10] Rent Report, December 2021: The State of the Rental Market, Apartmentguide.com, https://www.apartmentguide.com/blog/apartment-guide-annual-rent-report/
[11] National Association of Realtors, Median Sales Price of Existing Homes [HOSMEDUSM052N], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/HOSMEDUSM052N, January 12, 2022
[12] Bureau of Economic Analysis, Table 2.3.3. Real Personal Consumption Expenditures by Major Type of Product, Quantity Indexes.
[13] U.S. Energy Information Administration, Crude Oil Prices: West Texas Intermediate (WTI) - Cushing, Oklahoma.
[14] Source: https://www.washingtonpost.com/business/2022/01/20/workers-out-sick-omicron-census/

manufacturing. While the Fed also influences the cost of corporate borrowing by both being a buyer of corporate debt and the greaser of the bond markets' wheels, this influence primarily impacts future capital expenditures by increasing the cost of capital.

With headline inflation in the US spiking above 7% in December (the blue line in the chart below), the January 5th release of the minutes of the Federal Open Market Committee's most recent meeting caused quite a stir in equity



Data Source: US Bureau of Labor Statistics, data series CPIAUCSL and CPILFESL and Waypoint Advisors.

and bond markets. The minutes revealed that the committee discussed accelerating the reduction of its balance sheet, its holdings of US Treasuries and mortgage-backed securities (MBS), and possibly increasing the size and pace of rate hikes. This caused market trepidation for two reasons. First, balance sheet reduction has historically occurred 2 years after the liftoff of the Fed funds rate and the effects of an earlier combination of rate hikes and balance sheet reduction are not understood. Markets do not react well to uncertainty. Second, increasing the size and pace of rate hikes makes missteps by the Fed more likely. The balance between interest rates and economic growth is delicate. Imagine standing on one end of a seesaw and stepping towards the middle. Fast large steps make it easier to overstep the tipping point into recession.

How might interest rates impact equity markets

Higher interest rates do not necessarily have negative implications for equity markets. Prior to 2009 equity market returns generally did not diverge from bonds until the 10-year Treasury yield hit 4.5%. Since 2009 this threshold has decreased to 3.6%. As of 12/31/2021 the 10-year Treasury yield was 1.52%, leaving more than 2 percent of wiggle room until equities returns have historically shown a stronger pattern of divergence from 10-year Treasury yields.[15]

The dilemma that investors must navigate is that bonds, which provide little yield, are facing the risk of losing value as interest rates rise and equities are overvalued by a number of metrics. Bonds may not be as effective a ballast against equity market downturns as they have been in the past. In this environment, non-traditional diversification can be beneficial.

As stimulus fades and economic growth returns to normal, expect more volatility and lower returns

Equity valuations are well about their 20-year averages, bond yields are negative in real terms and the impacts of COVID, labor shortages in particular, continue to drive up inflation. There is plenty of liquidity to propel markets in the short run, but, as the economy slows, the high equity prices will likely adjust. As the effects of fiscal stimulus wane and the Federal Reserve accelerates its timeline for their final corporate and MBS purchases as well as interest

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[15] Source: JP Morgan Guide to the Markets, 12/31/2021.

rate hikes, market pundits forecast lower equity returns and higher market volatility over the next 5 years.[16] The bottom line is that there is significantly more uncertainty about the direction of markets and economies than there has been over the past 18 months and investor sentiment will swing more wildly as a result.

As bonds will be challenged, look to different ways to diversify

Traditional diversification comes in the form of a stock and bond portfolio with bonds providing income and negative correlation (usually increasing in value when equities decline). When rates are low and rising, bonds are negatively impacted. US bond markets returned less than 0.7% for the quarter and had negative returns for the year. Internationally, bonds posted negative returns of -1.2% and -7.1% for the quarter and year respectively.[17] Negative returns have continued through the first week of 2022 for both US and international bond markets.[17] Our current very low rate environment calls for something different. Portfolios need investments whose returns have little correlation to equity and bond market returns. These types of alternative investments come in a number of varieties that can cushion the blow of inevitable equity declines and avoid the negative impact on bonds as rates normalize. There are many tools that can be used to diversify portfolios, but in the end the goal is to provide returns similar to those of a traditionally diversified (stock and bond) portfolio with similar or lower risk.

[16] Northern Trust Asset Management, Goldman Sachs, BlackRock Investment Institute, Vanguard.

[17] US bonds are represented by the Bloomberg US Aggregate Bond index and the US Treasury 10 Year Bellweather. International bonds are represented by the Bloomberg Global Bond ex-US index. Data provided by Morningstar.