EAMON
CAPITAL MANAGEMENT

FOURTH QUARTER 2021 COMMENTARY AND 2022 OUTLOOK

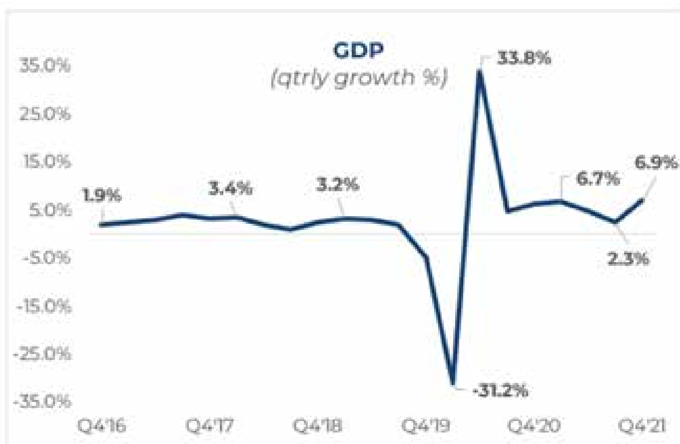
Goodbye 2021, Hello 2022 - We see 2022 heralding a similar pattern with solid global equity gains, albeit muted relative to the past three years, and continued downward pressure on bond prices for a second consecutive year.

It's rare for global stock returns to be positive while bonds returns are negative in any one year, let alone in back to back years. Frankly, this is something not observed since 1977. This unique performance pattern is being driven largely by uncertainty around the Fed response to record inflation combined with the headwinds relating to the Coronavirus pandemic and reopening of the economy. Overall, bond yields have been slower in responding to elevated inflation levels than in the past. If this continues it should keep real, or inflation-adjusted, bond yields historically low while underpinning equity market valuations — not withholding hefty volatility for risk assets in the short- to intermediate- term.

Economy

GDP

From an economic perspective, it was largely the same themes in Q4 as seen in Q3, with robust GDP growth, multi-decade high inflation levels, and continued labor shortages. As consumer balance sheets remain strong and household savings levels are at some of the highest levels ever observed, GDP experienced supernormal growth rates in 2021.

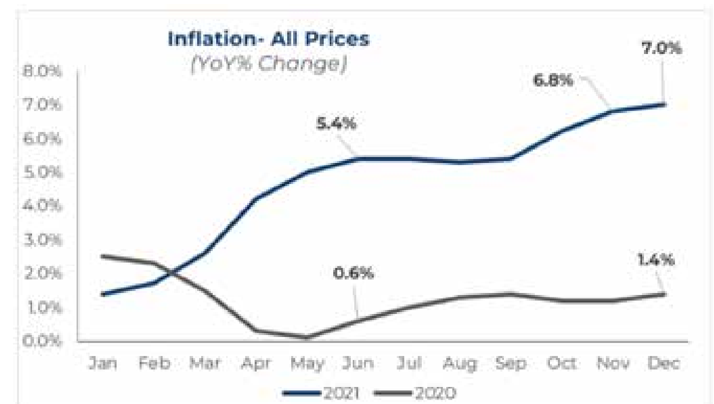


Source: FRB St. Louis, FRED

In Q4, GDP growth hit 6.9% putting full year 2021 growth at 5.9% and in line with revised forecasts for the year. However, 2022 growth rates are getting revised downward as softness has begun to emerge in business activity. For example, 5% of the 6.9% growth rate in Q4 was due to inventory builds – the second biggest impact from inventory in forty years – as businesses raced to rebuild depleted inventories ahead of the holiday season. Absent this inventory replenishment activity, GDP growth was closer to 2%.

Inflation

U.S. retail goods price inflation was very strong again in December – with household goods and apparel seeing particularly strong gains. In general, U.S. retailers successfully navigated the holiday shopping season by warning customers to shop early in order to avoid depleted inventory. This provided price support and lower discounting than usual, despite consumption moderating into the late part of the quarter.



Source: BLS

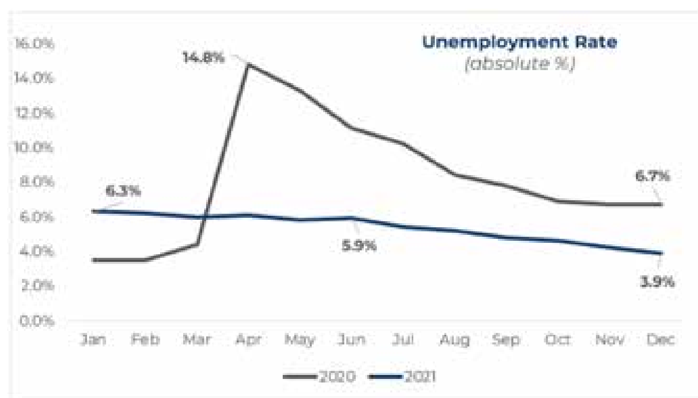
Elsewhere, improved demand for domestic travel around the holidays drove price gains. U.S. airfares continued to recover from Q3 weakness despite overall airfare prices still remaining well below pre-COVID levels. While airfares are expected to recover, the omicron variant was certainly a near-term headwind. With many companies once again

delaying return-to-office plans and continuing virtual business it may prolong expectations for a recovery in higher-priced corporate travel. Hotel prices remain elevated above pre-COVID levels, as demand is still very strong for drive-to travel destinations and many properties are still restricting capacity.

Finally, auto prices once again were very strong. Used car price inflation jumped to 3.5% while new vehicle prices rose 1.0% month-over-month. Semiconductor shortages, record low inventories, and pandemic demand continue to create a perfect storm in the auto industry. Indicators point to improvement in the months ahead, however it will still take some time for overall inventories to recover.

Unemployment

The labor market continues to gain significant traction grinding its way back toward prepandemic levels as the December unemployment rate came in at 3.9%. Private-sector nonfarm payrolls grew by 211,000 for the month. This was well below consensus estimates expecting around 400,000 or more. As confounding as this softer gain might seem relative to expectations, it is in line with the trends of recent

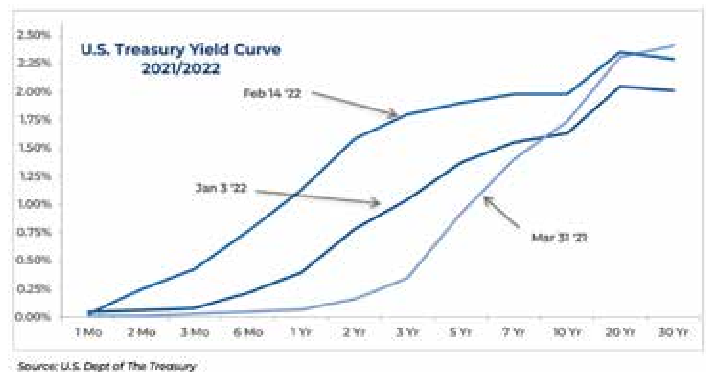


Source: BLS

months showing slowing job growth since last spring. Perhaps slower growth in November and December will be followed by better gains in early-2022. Even so, at this pace, it would take the economy another two years to re-attain pre-Covid payroll job growth trends. Meanwhile, with the holidays behind us, many expect labor force growth to accelerate with the expiration of extended unemployment benefits. If this happens and job growth remains 300,000 per month or less, the unemployment rate will rise.

Interest Rates/Yield Curve

As the bond markets continued to digest potential scenarios for shifting macroeconomic and monetary policy, yields were increasingly volatile throughout the tailend of 2021. As shown by the graph below, we saw the steepest yield curve near the end of March as the U.S. 10-year Treasury climbed 50 basis points to 1.74%. However, by year's end, the curve flattened significantly with front-end yields rising more than the back-end yields. The U.S. 2-year Treasury began 2021 at 0.11% only to jump 65 basis points to 0.76% while the U.S. 20-year Treasury increased by just over 35 basis points over the same period.



Source: U.S. Dept of The Treasury

A flattening yield curve generally indicates interest rates will be lower in the future, i.e., slowing economic growth and lower inflation, while a steepening yield curve indicates higher rates in the future, i.e., strong economic growth and higher inflation. On average, the yield curve has been a strong predictor of forward looking economic growth in the U.S. As of the writing of this commentary, the yield curve has flattened significantly more than the levels seen at the end of December.

Markets

U.S. Equities

Domestic equities capped off a stellar year with a strong quarter, as both **large-cap** and **mid-cap** posted mid single digit returns while **small-cap**, despite being positive on an absolute basis, trailed its larger counterparts. For 2021, all capitalizations had double-digit returns for the third consecutive year as shown by the *Russell 1000 Index* +26.5%, *Russell Mid Cap Index* +22.6%, and *Russell 2000 Index* +14.8%.

	DEC %	QTD %	Trailing[1] 1-Yr %	Trailing[1] 3-Yrs %	Trailing[1] 5-Yrs %
U.S. Large Cap Equity					
S&P 500 Index	4.5	11.0	28.7	89.3	122.4
DJ Industrial Average Index	5.5	7.9	20.9	58.5	97.8
Russell 1000 Index	4.1	9.8	26.5	91.3	123.2
Russell 1000 Growth Index	2.1	11.6	27.6	129.4	197.4
Russell 1000 Value Index	6.3	7.8	25.2	55.0	62.0
U.S. Mid Cap Equity					
Russell Mid Cap Index	4.1	6.4	22.6	81.0	95.5
Russell Mid Cap Growth Index	0.4	2.8	12.7	104.2	144.2
Russell Mid Cap Value Index	6.3	8.5	28.3	62.6	61.6
U.S. Small Cap Equity					
Russell 2000 Index	2.2	2.1	14.8	70.8	74.2
Russell 2000 Growth Index	0.4	0.0	2.8	77.9	97.1
Russell 2000 Value Index	4.1	4.4	28.3	59.9	50.0

From a style perspective, **value** outperformed **growth** in December with mixed results for 2021 as **value** outperformed in **mid**- to **small- capitalizations** (*Russell Mid Cap Value Index* +28.3% and *Russell 2000 Value Index* +28.3%) and **growth** outperformed in **large-cap**. The best performer across all market capitalizations was the *S&P 500 Index* +28.7%, led by the subjectively priced FAANG stock consortium, while the *Russell 2000 Growth Index* +2.8% was the worst performer for the year.

Developed and Emerging Market Equities

International equity markets rebounded from Q3 losses, with the *MSCI ACWI ex USA Index* up +1.8% and the *MSCI EAFE Index* +2.7%. The difference in performance between the two indices was due to Emerging Markets, which were down -1.3% led by China (-6.0%). Emerging Markets are included in the *ACWI ex USA Index* but not the developed markets *MSCI EAFE Index*. International Small Cap struggled, in line with its U.S. counterparts, ending largely flat despite a strong December, as shown by *MSCI ACWI ex US Small Cap Index* +0.6%

	DEC %	QTD %	Trailing[1] 1-Yr %	Trailing[1] 3-Yrs %	Trailing[1] 5-Yrs %
International & Emerging Market Equity					
MSCI EAFE Index	5.1	2.7	11.3	43.7	55.1
MSCI EAFE Growth Index	4.3	4.1	11.3	64.2	85.0
MSCI EAFE Value Index	6.0	1.2	10.9	24.2	28.6
MSCI Emerging Markets Index	1.9	-1.3	-2.5	37.9	61.4
MSCI ACWI ex. U.S. Small Cap	4.2	0.6	12.9	57.3	69.5

From a sector perspective, *Energy*, *Financials*, and *Information Technology* were the leading sectors for the year, while *Communication Services*, *Consumer Discretionary*, and *Real Estate* posted negative returns. From a country perspective, *Developed Markets* posted the best returns, led by the **UK**, **Europe**, and **Canada**. Emerging Markets trailed, led by losses in **China** and **Brazil** while **India**, **Mexico**, and **Russia** were notable outperformers.

Fixed Income

Overall, the trends seen in Q3 continued to the end of the year. Inflation concerns, pandemic uncertainty, and the focus on continued central bank accommodation, or lack thereof, all contributed to higher interest rate volatility which weighed heavily on performance in the asset class. Generally, fixed income is considered a ballast for portfolio asset allocations, however, as its correlation with equities increased substantially during the year, it made a poor diversifier relative to other risk assets. This has led to underperformance in portfolios with more balanced asset allocations, i.e., both stocks and bonds.

	DEC %	QTD %	Trailing[1] 1-Yr %	Trailing[1] 3-Yrs %	Trailing[1] 5-Yrs %
Fixed Income (U.S. & Emerging)					
Bloomberg US Agg. Bond Index	-0.3	0.0	-1.5	15.1	19.2
Bloomberg US Agg Int. Bond Index	-0.1	-0.5	-1.3	11.7	15.3
Bloomberg US Int. Corporate Index	0.1	-0.6	-1.0	16.6	20.9
Bloomberg US Long Corporate Index	-0.4	1.5	-1.1	38.1	43.6
ICE BofA US High Yield Corp Index	1.9	0.7	5.4	27.3	33.8
Bloomberg US TIPS Index	0.3	2.4	6.0	25.2	27.3
JPM EMBI Global Diversified Index	1.4	-0.4	-1.8	19.4	26.0
JPM GBI-EM Global Diversified Index	1.6	-2.5	-8.7	8.9	17.4

We expect an extremely bumpy road for the first half of 2022 as investors pay close attention to economic indicators with subsequent adjustments to fresh data causing ripples across asset classes. As such, we anticipate continued interest rate, equity, and other risk asset volatility at least through June of 2022.

The *Bloomberg U.S. Aggregate Bond Index* was flat for the quarter and down -1.5% for 2021 as its longer duration stance proved a strong headwind in the face of rising interest rates. However, as inflation hit record highs, the *Bloomberg U.S. TIPS Index* was the top performer up +6.0%. Investment grade credit struggled as shown by the *Bloomberg US Long Corp Index* -1.1% and *Bloomberg US Int. Corp Index* -1.0% both being down for 2021, despite slightly better results for the quarter. However, as yield starved investors sought out risk, there was hefty demand for lower quality credit as shown by the *ICE BofA US High Yield Corp Index* beating out its higher quality counterparts by being up +5.4% over the same period. From a non-U.S. perspective, **U.S. dollar-denominated** and **local currency emerging market debt** were by far the worst performers as shown by the *JP Morgan EMBI Global Diversified Index* (USD) -1.8% and *JP Morgan EMBI Global Diversified Index* (local currency) -8.7%. Despite the selloff in emerging markets, several are pointing to the sector being oversold and priced for distressed levels making it an attractive opportunity in 2022.

Outlook

"Buckle Up!"

Our outlook from Q3 remains largely intact with a few updates as we head into 2022. Overall, as excess demand makes its way through the system and supply chain issues correct themselves, we expect GDP, inflation, and unemployment to slow from current elevated levels in 2022. This is evident as we continue to see forecasts for growth adjusted downward. The FOMC expects GDP of 4.0% for 2022, 2.25% for 2023, and then 1.9% for 2024. On the inflation front, the FOMC adjusted forecasts upward, albeit very minimally, expecting PCE inflation of 2.75% (vs. 2.25%) for 2022, 2.25% (vs. 2.15%) for 2023, and then 2.1% (vs. 2.1%) for 2024. This upward adjustment is pointing to a slightly longer staying power than previously expected, related to omicron, but still well below the levels of 2021.

The labor market could take much longer to recover as there are still several million workers unemployed. While the most recent jobs report showed what looked like massive gains in employment, due to prior period adjustments back to 2020, on net it showed really no increases in job growth. Assuming the economy continues to add jobs at a pace of 300k-450k a month, it will take around eighteen to twenty-four months to reach prepandemic employment levels.

We expect an extremely bumpy road for the first half of 2022 as investors pay close attention to economic indicators with subsequent adjustments to fresh data causing ripples across asset classes. As such, we anticipate continued interest rate, equity, and other risk asset volatility at least through June of 2022.

Investment Strategy/Asset Allocation

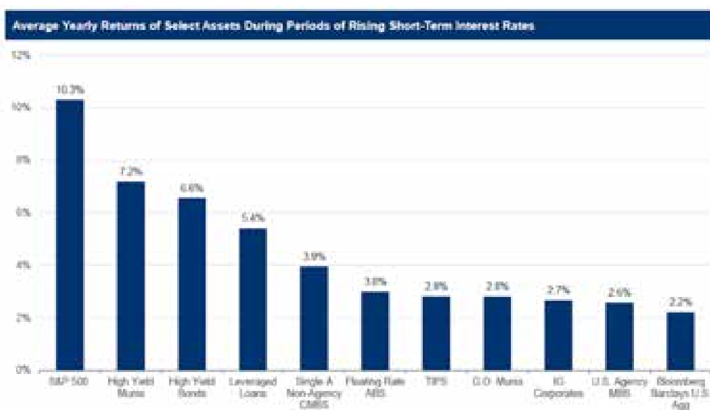
We have upgraded our view from **underweight** to **neutral** and **slightly overweight** on select **equities**, and adjusted our **fixed income** view from **overweight long-duration**, i.e., higher interest rate sensitivity, in favor of **overweight short-duration**, i.e., lower interest sensitivity, for the first half of 2022. Where allowed, we are adding more **alternative asset** exposure, through absolute-return strategies, as a source of uncorrelated return to traditional asset classes.

Given the recent selloff in equities year-to-date 2022, with the *Russell 1000 Index* -5.4%, *Russell Midcap Index* -6.5%, and *Russell 2000 Index* -9.0% all significantly down, we are now more favorable on equities at these valuations. However, we are

not favorable across the board but rather focused on fundamentals and those companies already exhibiting quality and profitability factors. As interest rates rise, speculative growth names have been hit the hardest as the market reevaluates long-term earnings growth estimates and discounting at higher rates back to today. We believe companies with strong, current profitability and high free cash flow metrics are best suited to weather higher short-term inflation, easing monetary policy, and general market volatility.

For fixed income, we do see a potentially tough year for the asset class as monetary tightening and removal of monetary stimulus causes downward repricing of the broader bond market. Within this backdrop, we do see bonds as offering a high level of income as yields move higher but with more price volatility especially for longer-dated bonds. As such, we have been reducing duration since November 2021 and now sit near 2 years for most portfolios. From a sector perspective, we favor short-duration investment grade credit, high yield credit, securitized credit (ABS, CMBS, non-Agency MBS, and CLOs), and local-currency denominated emerging market debt. As rates level off, and growth and inflation begin to slow, we will look to extend duration as, in this scenario, yields would likely move lower. Historically, on average, most tightening cycles have proven beneficial for the performance of non core fixed income (see graph) such as high yield corporate credit, emerging market debt, and securitized credit and we have increased our allocation to these sectors heading into 2022.

> To reiterate, as long-term investors, we are willing to accept short-term underperformance in exchange for longer-term outperformance as the markets sift through the noise and reprice assets. Stay the course, stay invested.



Right before the pandemic, around December 2019/ January 2020, post the tightening cycle of 2018, the U.S. 10-year Treasury yield was back in a range of 1.80%-1.90%, after hitting levels near 3.25% during that period. We still believe the headwinds facing the economy prior to the pandemic remain today, and are more entrenched now, as we head into this next period of rate hikes.

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