HIGHTOWER
Westchester

Market Commentary Q4 2021

There is no better way to describe it, 2021 was a historic year for the markets. To begin the year, we were still very much in the throes of the COVID-19 scare, yet the market viewed the world with a bit more optimism. As the global economy continued to rebound from pandemic lows, we witnessed the first COVID-19 vaccines, accommodative U.S. monetary policy, historically low Interest rates, and bolstered consumer savings. That translated into a strong year for equities with the S&P 500 finishing the year up 28.7% on a total return basis.[1] It was the 21st best year since 1926 and posted a max drawdown of only 5.2%, which is the fourth smallest pullback since 1987![1] And despite the heightened volatility, the S&P 500 made seventy new highs in 2021, second best of all time. [1]

Leading US Indices (Total Return)	3Q'20	4Q'20	2020	1Q'21	2Q'21	3Q'21	4Q'21 (sorted)	YTD
S&P/Citigroup Growth	11.8%	10.7%	33.5%	2.1%	11.9%	1.9%	13.4%	32.0%
S&P 100 Mega-Cap	9.8%	10.7%	21.5%	5.1%	9.4%	1.0%	11.3%	29.4%
S&P 500 Total Return	**8.9%**	**12.1%**	**18.4%**	**6.2%**	**8.5%**	**0.6%**	**11.0%**	**28.7%**
Nasdaq	11.2%	15.6%	44.9%	3.0%	9.7%	-0.2%	8.4%	22.2%
S&P/Citigroup Value	9.0%	14.4%	20.0%	5.8%	8.1%	-0.6%	8.1%	22.8%
Dow Jones Wilshire 5000	4.8%	14.5%	1.4%	10.8%	5.0%	-0.8%	8.3%	24.9%
S&P 400 Mid-Cap	4.8%	24.4%	13.7%	13.5%	3.6%	-1.8%	8.0%	24.8%
S&P 600 Small-Cap	3.2%	31.3%	11.3%	18.2%	4.5%	-2.8%	5.6%	26.8%
Russell 2000	4.9%	31.4%	20.0%	12.7%	4.3%	-4.4%	2.1%	14.8%

S&P 500 Sectors (Total Return)	3Q'20	4Q'20	2020	1Q'21	2Q'21	3Q'21	4Q'21 (sorted)	YTD
Real Estate	1.9%	4.9%	-2.2%	9.0%	13.1%	0.9%	17.5%	46.2%
Technology	12.0%	11.8%	43.9%	2.0%	11.6%	1.3%	16.7%	34.5%
Materials	13.3%	14.5%	20.7%	9.1%	5.0%	-3.5%	15.2%	27.3%
Staples	10.4%	6.4%	10.7%	1.1%	3.8%	-0.3%	13.3%	18.6%
Utilities	6.1%	6.5%	0.5%	2.8%	-0.4%	1.8%	12.9%	17.7%
Discretionary	15.1%	8.0%	33.3%	3.1%	6.9%	0.0%	12.8%	24.4%
Health Care	5.9%	8.0%	13.4%	3.2%	8.4%	1.4%	11.2%	26.1%
S&P 500 Total Return	**8.9%**	**12.1%**	**18.4%**	**6.2%**	**8.5%**	**0.6%**	**11.0%**	**28.7%**
Industrials	12.5%	15.7%	11.1%	11.4%	4.5%	-4.2%	8.6%	21.1%
Energy	-19.7%	27.8%	-33.7%	30.9%	11.3%	-1.7%	8.0%	54.6%
Financials	4.4%	23.2%	-1.7%	16.0%	8.4%	2.7%	4.6%	35.0%
Communication Services	8.9%	13.8%	23.6%	8.1%	10.7%	1.6%	0.0%	21.6%

US Yields	3Q'20	4Q'20	1Q'21	2Q'21	3Q'21	4Q'21	Q/Q Chg (bps)	Y/Y Chg (bps)
Fed Funds Target Rate	0.25	0.25	0.25	0.25	0.25	0.25	0	0
3-Month T-Bill	0.09	0.08	0.01	0.05	0.04	0.05	2	-3
2-Year Note	0.13	0.11	0.11	0.25	0.28	0.20	-8	9
5-Year Note	0.26	0.31	0.74	0.69	0.74	1.07	33	76
10-Year Bond	0.66	0.87	1.70	1.40	1.46	1.44	-2	57
30-Year Bond	1.45	1.64	2.42	2.07	2.09	1.89	-20	25

Source – Strategas Securities, LLC

The fourth quarter began with a continuation of the same volatility that we saw at the end of the third quarter. As is said often in our industry, we continued to climb a wall of worry as the quarter progressed. There was an abundance of political uncertainty as we saw little progress in Washington on extending the debt ceiling, avoiding a government shutdown, or providing investors clarity on future tax changes contained in the Build Back Better bill. That all combined for a poor start to the quarter. Yet as the weeks rolled on, the powers that be were able to put those worries to rest…for now!

At the Congressional testimony in November, Federal Reserve ("Fed") Chairman Jerome Powell stated that due to persistently high inflation, the Fed would most likely need to accelerate the tapering of quantitative easing ("QE"), which came as a surprise to markets. Powell forecasted doubling the pace of reduction, causing markets to price in sooner-than-expected-interest rate hikes in 2022. These concerns combined with the new Omicron variant, led to declines in stocks late in the month and the S&P 500 finished with a slight loss.

December was a bit more positive in terms of Washington guidance and governments not imposing economically crippling lockdowns in response to the surging Omicron outbreak. We got more concreate news on the acceleration of tapering and its end in March of 2022. The Fed also signaled it expected to raise interest rates three times in 2022 to combat rising inflation.

When it comes to the topic du jour, inflation, you will find differing opinions from most market pundits. As we know, the bottlenecks and global supply chain issues caused by the COVID lockdowns helped kickstart this price jump. Demand for goods vs. services were turned on their heads post March 2020. Basically, consumers bought three years' worth of stuff in a year (e.g., household supplies, computers, TVs, household appliances, sports equipment, etc.)! Yet with the pandemic slowly transitioning to somewhat of an endemic, the hope is that consumers will shift back from spending on stuff to spending on services. Indeed, we are seeing consumer spending getting back to trend levels recently with not only above trend spending on goods but also on services.[2] At the end of November, and again recently, we saw an almost 7% year-over-year inflation print. There are two parts of inflation that will likely be stickier than others and those are wages and higher rents.

Employment has been very strong, with a tight labor market and rising wages. Several large reputable firms raised their wages across both low and high paying jobs in 2021. The near-term outlook for the labor market suggests workers are likely to continue to have considerable bargaining power in the new year. While more workers may enter the labor market if the virus worries subside and things like childcare come back to pre-pandemic levels, demand for workers seems likely to be strong this year.

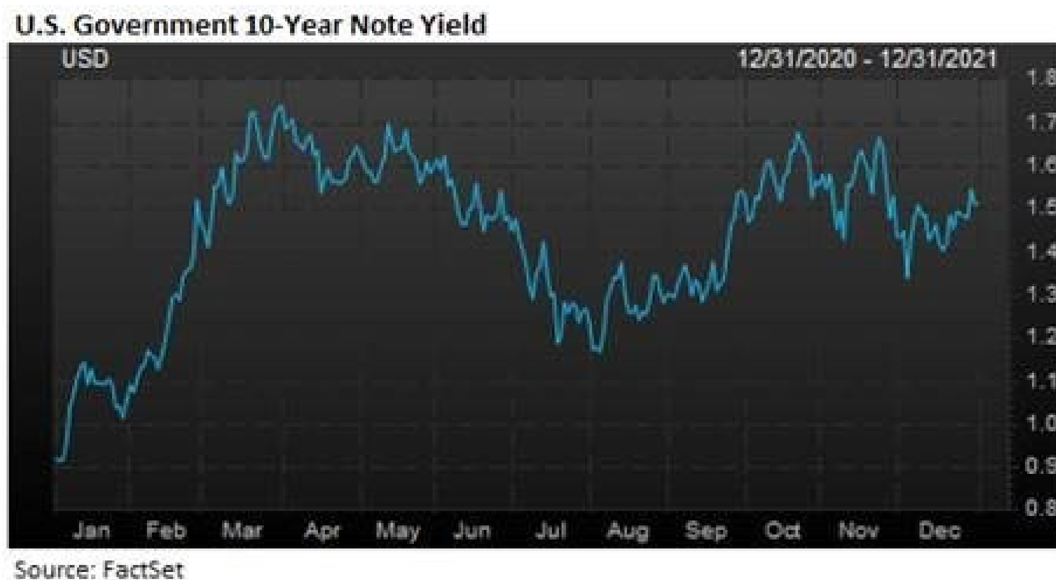
Manufacturing, which is about 12% of U.S. GDP, should be positively impacted by the infrastructure bill that was recently passed.[1]

Last year there was plenty of dispersion across sectors and themes. Value and Growth stocks ended 2021 with similar performance, but there was significant disparity intra-quarter, particularly in the first half of the year, which provided enhanced rebalancing opportunities. A late-year rally in large cap technology helped growth outperform value both in the fourth quarter and for the full year. We made a shift into value midyear and despite being a bit early, we've started seeing the benefits of the trade

over the last few months. The S&P 500 outperformed the NASDAQ for the first time since 2016 and the second time since 2011.[1] Real estate was one of the best performing asset classes in 2021, on the back of favorable supply-demand dynamics, which helped buoy property prices after experiencing a weak 2020. For 2021, however, energy was by far the best-performing sector in the market due to a surge in oil and natural gas. Technology and financials were also strong performers. In terms of market capitalization, large caps outperformed small caps both in the fourth quarter and throughout 2021.

Shifting our attention to the fixed income markets, where overall there was not a great deal of movement, bond yields ended the year higher, with the 10-year Treasury yield finishing the year at 1.51%, up from 0.91% at the beginning of the year.[1] Consequentially, the bond market, as measured by the Bloomberg U.S. Aggregate Bond Index, finished the year down -1.54%.[1]

Inflation concerns weighed on the bond market, and the Fed's policy pivot announcement put upward pressure on interest rates due to the accelerated tapering timeline and signaling the likelihood of multiple interest rate increases in the year ahead.



Given this backdrop and outlook, we have positioned our fixed income allocation to maintain less duration risk, or interest rate sensitivity, than the broad bond market and are avoiding fixed income securities most susceptible to rising interest rates, i.e., long duration bonds. This has been our positioning for some time now and it has paid off.

When it came to municipal bonds, we saw strong inflows and demand in 2021 with limited growth in supply. That, in turn, led to low ratios and tight spreads throughout the year. We also witnessed more than $1 trillion of federal aid to municipal bond issuers during COVID.[1] This led to low default rates in 2021 (57 YTD through November 2021 vs. 72 for full year 2020), robust public

sector revenue growth, and liquidity in the market.[1] We are keeping an eye out for the following risks: inflation, labor shortages, disruption to public schools, etc., all of which could negatively impact bond prices.

Outside of the U.S., we saw a lot of the same challenges both economically and around COVID. Internationally, markets saw modest gains in the fourth quarter as declines in emerging markets partially offset gains in developed markets. Emerging markets dropped in the fourth quarter in reaction to a stronger U.S. dollar while the Omicron variant also weighed on global economic growth estimates. Developed international markets posted a positive return for the quarter, although they badly underperformed the S&P 500. For the full year 2021, international markets registered solid returns, but again, handily underperformed the S&P 500.

International Indices (Price Chg)	3Q'20	4Q'20	2020	1Q'21	2Q'21	3Q'21	4Q'21 (sorted)	YTD
Swiss Market Index	1.4%	5.1%	0.8%	3.2%	8.1%	-2.5%	10.6%	20.3%
CAC 40 (France)	-2.7%	15.6%	-7.1%	9.3%	7.3%	0.2%	9.7%	28.9%
OMX Stockholm 30 (Sweden)	9.9%	2.5%	5.8%	17.0%	3.2%	-0.2%	7.1%	29.1%
S&P/TSX (Canada)	3.9%	8.1%	2.2%	7.3%	7.8%	-0.5%	5.7%	21.7%
Shenzhen SE A Shares (China)	8.8%	8.4%	35.2%	-4.8%	11.2%	-2.9%	5.6%	8.6%
FTSE 100 (UK)	-4.9%	10.1%	-14.3%	3.9%	4.8%	0.7%	4.2%	14.3%
DAX (Germany)	3.2%	7.4%	0.4%	9.1%	1.5%	-1.8%	4.1%	13.0%
Bolsa (Mexico)	-0.7%	17.6%	1.2%	7.2%	6.4%	2.2%	3.7%	20.9%
All Ordinaries (Australia)	**0.1%**	**14.0%**	**0.7%**	**2.4%**	**8.1%**	**0.6%**	**2.0%**	13.6%
IBEX 35 (Spain)	-7.1%	20.2%	-15.5%	6.3%	2.8%	-0.3%	-0.9%	7.9%
Sensex (India)	9.0%	25.4%	15.8%	3.7%	6.0%	12.7%	-1.5%	22.0%
Nikkei 225 (Japan)	4.0%	18.4%	16.0%	6.3%	-1.3%	2.3%	-2.2%	4.9%
Kospi (South Korea)	10.4%	23.4%	30.8%	6.5%	7.7%	-6.9%	-3.0%	3.6%
Hang Seng (Hong Kong)	-4.0%	16.1%	-3.4%	4.2%	1.6%	-14.8%	-4.8%	-14.1%
Bovespa (Brazil)	-0.5%	25.8%	2.9%	-2.0%	8.7%	-12.5%	-5.5%	-11.9%

Source – Strategas Securities, LLC

China, the world's second largest economy, had an up and down year by any measure. They were the only major economy to record growth in 2020, but this past year it dealt with a lot of threats to its expansion, including pandemic-related lockdowns, an energy crunch, and an unprecedented crackdown on private enterprises. We witnessed a sweeping regulatory crackdown on businesses, technology, and education. All of which hurt markets significantly and triggered layoffs among many companies, adding further pressure on the job markets as it tried to recover from the pandemic. The new prints are showing China grew over 8% last year, but as we move into the new year, they have many challenges to overcome.

Commodities saw gains in the quarter as both oil and gold posted positive returns. Oil rallied late in the quarter on fading concerns that Omicron would materially impact consumer demand for refined products around the globe. Gold, which has had a strange ride the last 18 months, saw a small gain in the fourth quarter thanks to continued elevated inflation readings, a decline in the U.S. dollar, and a general increase in market volatility. For the year, commodities posted a strong return as the global economy

reopened and demand increased amidst still-constrained supply thanks to a disciplined OPEC+ group. Gold, however, saw a slightly negative return for 2021 as the increasing attractiveness of alternative investments, such as Bitcoin and other cryptocurrencies, combined with a stronger dollar weighed on the precious metal.

It has been a very unusual time in the economy and markets. Everything has moved up at warp speed in terms of economic change. We have seen an unprecedented amount of liquidity both from monetary and fiscal policy. At one point we had 60% of U.S. GDP pumped into the system vs. 8% after the great financial crisis of 2008! [1] We are seeing the effects of this cheap money across companies' balance sheets and their stock prices as well as in the personal savings rates.

As we turn our attention to 2022, there are several key investment themes that we will be watching.

First, the Fed, its taper, and rates. The federal funds rate has followed wage growth for decades. The wage growth line now is screaming for the Fed to raise interest rates, so we expect to have some increases. Can the U.S. economy survive higher real yields? The short answer is yes, so long as the adjustment is orderly. It is also possible we see a knee jerk sell off from markets when rate hikes come to fruition. Assets that look more exposed to such a shift in real yields are long-duration bonds and overvalued growth stocks, while value-oriented investments such as financials and energy should continue to do well.

Geopolitical resolve and our relationships with China and Russia are something that should dominate headlines. While it seems a world away, the world is more connected than it has ever been. In addition, COVID-19 has not gone away and seems here to stay with new virus variant worries that seem to rear their ugly head every few months. We hope just as much as anyone that these worries subside but are prepared for the worst.

It's safe to say there are more headwinds for risk assets and the economy in 2022. We have been spoiled with performance the last decade and we should expect an elevated level of volatility with potentially moderate equity returns in the near team. As always, the team believes that a long-term balanced approach, focused on fundamentals, is the best investment strategy. We remain as vigilant as ever to stay invested, remain patient, and stick to the plans set forth.

We wish you all a healthy and successful 2022.

To discuss this commentary further, please contact us at 914-825-8630.

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[1] Strategas Securities, LLC
[2] Cornerstone Macro, LLC

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