



## Fourth Quarter 2021 Commentary

Dear Clients,

Please find enclosed your December 31, 2021 Investment Reports.

It was quite a remarkable year for the U.S. stock market. Not only did large-cap U.S. stocks return a strong 27.6%, nearly triple the long-term historical average, but for only the second time in market history, the index reached a new high in each month of the year. Large-cap U.S. stocks outperformed small-cap stocks which were up 17.7%. Developed international stocks returned 11.8% and emerging-market (EM) stocks were flat at 0.1% for the year. The renewed surge in COVID-19 infections late in the year (particularly in Europe and emerging markets) and China's policy-induced economic slowdown were key drivers of this relative under-performance for EM stocks. The MSCI China Index plunged 21.7% for the year and lost 6.1% in the fourth quarter. Chinese stocks comprise roughly 35% of the MSCI EM Index. The MSCI EM ex-China Index gained 10.0% for the year.

Also contributing to the underperformance of international stocks for U.S.-based investors was the strength in the dollar. After falling early in the year, the U.S. dollar index appreciated sharply, ending the year with a 6.3% gain. A rising dollar is a negative when translating foreign market local-currency returns into U.S. dollar-based returns.

Looking beneath the surface of the U.S. market, value and growth stock indexes both returned over 25% in 2021, but a strong rally in growth stocks in the second half of the year gave growth a slight edge over value once again for the year. However, two of the three top-performing sectors were cyclical value sectors: energy (up 54.6%) and financials (up 35.0%).

### Benchmark Returns

	Last Quarter	Last Twelve Months	Last Five Years
US Large Cap Stocks	10.6	27.6	19.3
US Mid Cap Stocks	8.0	24.5	15.9
US Small Cap Stocks	3.9	17.7	13.5
Developed International Stocks	2.8	11.8	10.4
Emerging Market Stocks	-1.0	0.1	9.9
US Bonds	0.0	-1.5	3.6
Global Bonds	-1.2	-7.0	3.1
US REITs	16.0	41.7	9.5

Data source: Morningstar Direct. Past performance does not guarantee future results. It is not possible to invest directly in an index. Last five years data is annualized. Market indexes include:

US Large Cap Stocks: CRSP US Mega Cap TR USD  
US Mid Cap Stocks: CRSP US Mid Cap TR USD  
US Small Cap Stocks: CRSP US Small Cap TR USD  
Emerging Market Stocks: FTSE Emerging TR USD  
Developed International Stocks: FTSE Developed Ex US TR USD  
US Bonds: Barclays US Aggregate Bond TR USD  
Global Bonds: Barclays Global Aggregate Ex USD TR USD  
US REITs: MSCI US REIT NR USD

The other top performing sectors were real estate (up 46.2%) and information technology (up 34.5%). The worst-performing sectors were traditional "defensive" sectors: utilities (up 17.7%) and consumer staples (up 18.6%).

Turning to the bond markets, the core U. S. bond index lost 1.5% for the year, as interest rates rose moderately. The benchmark 10-year Treasury bond yield ended the year at 1.51%, compared to a 0.92% yield at the end of 2020. Given the very sharp rise in inflation, most analysts would likely have predicted a much sharper increase in bond yields.

As has been the case for the past 21 months, COVID-19 remains a key variable for the short term economic



and market outlook. New antiviral drugs are the latest positive medical development in the ongoing battle against the spread of more transmissible variants of the virus. If the pandemic recedes in 2022 as seems likely, the current pandemic-related supply chain disruptions, U.S. labor market anomalies, and consumer demand distortions should also recede. This should both support overall economic growth and mitigate at least some of the inflationary pressures the U.S. and global economies experienced in 2021 related to supply/demand mismatches.

In addition to the evolution of the pandemic, U.S. monetary and fiscal policy will have important impacts on economic growth, inflation, and the financial markets in 2022. At its December Federal Open Market Committee (FOMC) meeting, the Federal Reserve expressed increasing concern about inflation and signaled it would accelerate its timeline and pace for interest rate hikes in 2022. Current expectations are for three rate hikes in 2022 and three more in 2023. In his comments after the FOMC meeting, Fed chair Jerome Powell noted that core inflation has broadened beyond the industries most impacted by the pandemic and is well above the Fed's 2% average inflation target. He also cited a range of economic indicators that suggest the labor market is rapidly tightening (for example, a falling unemployment rate, rising wage growth, abundant job openings, and high employee quit rates). "In my view," said Powell, "we are making rapid progress toward maximum employment." Powell also highlighted the importance of keeping inflation expectations in check to prevent a self-fulfilling inflationary spiral.

The consensus forecasts for economic growth and inflation in 2022 envision decelerating growth and moderating inflation, but both still meaningfully above the economy's longer-term trend. According to Bloomberg's survey of economists, the consensus expects roughly 4% real GDP growth for the United States (same as the FOMC's forecast) and slightly higher growth for Europe in 2022. This compares to around

5.5% (U.S.) and 5% (Europe) growth in 2021. Total global real GDP grew at roughly 5.6% in 2021—its fastest pace since 1980—and the consensus expects growth in the 4.5%–5.0% range in 2022.

As always, equity investors should expect market volatility and be prepared for fluctuations in portfolio values. As for the impact of increasing interest rates

on markets, there is not a tight historical relationship between the initial Fed rate hike and U.S. stock market performance. History does show that the S&P 500 has typically had solid returns over the course of the first year of a tightening cycle. However, if the Fed initiates a "fast" rate hike cycle, where it raises the federal funds rate at a pace that exceeds market expectations, the market has usually fared poorly. While the Fed has been broadcasting a hawkish policy stance, it remains to be seen if, when, and to what extent

it will follow through with the expected rate hikes. It is also important to remember that interest rates and market performance may well be impacted by COVID-related economic developments which are highly unpredictable.

We are confident in our long-term investment process and portfolio management discipline, and we are committed to helping you achieve your investment and financial goals. We sincerely appreciate your confidence and trust as well.

From all of us at Leavell Investment Management, we wish you and yours a healthy, happy and prosperous New Year.

**Leavell Investment Management, Inc.**