RDM CAPITAL ASSOCIATES

WEALTH MANAGEMENT

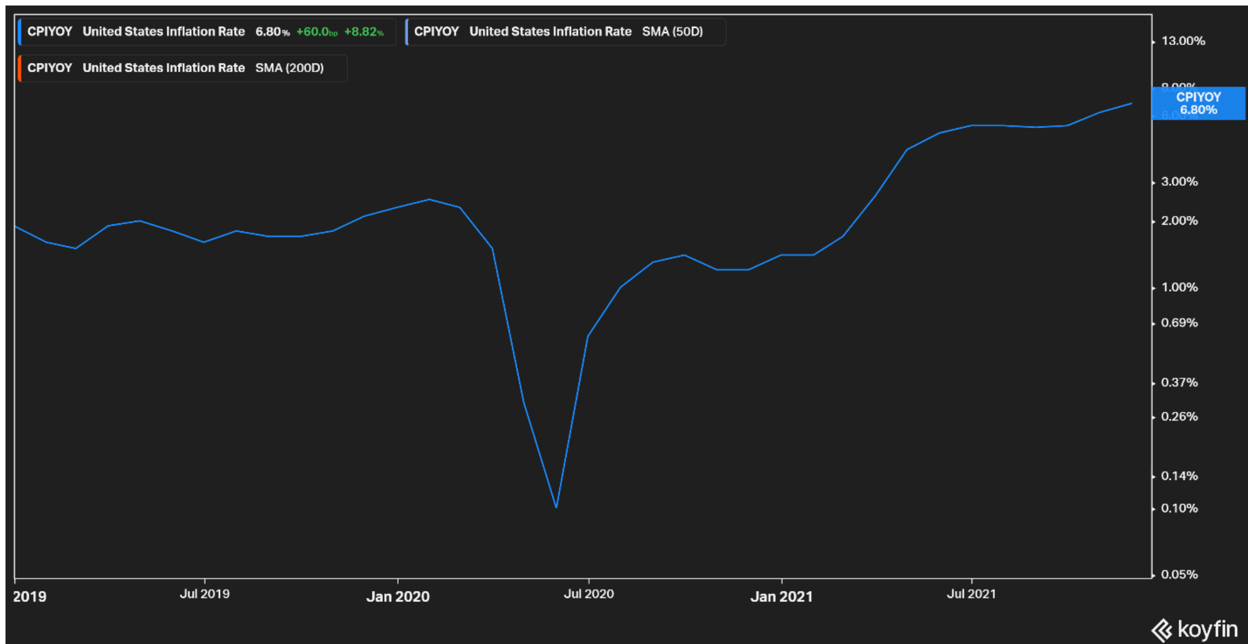
Fourth Quarter 2021 Market Commentary

January 2022

Shifting Monetary Policy and Variant Trends Sway Markets

Market behavior was influenced by competing forces at year-end: 1) higher inflation data causing the Federal Reserve to tighten monetary policy conditions and 2) an upsurge in COVID-19 cases due to the newly emerged omicron variant. The S&P 500 finished the quarter up 9% and 27% for 2021. Top performing sectors for the year include energy (53%), financials (36%) and technology (36%), reflecting a shift, in part, towards more interest rate and inflation-sensitive cyclical sectors and away from more defensive sectors. Much of this shift is attributable to a sense of economic re-opening and strong corporate earnings growth on the back of the 2020 pandemic that still lingers.

Economically, the most closely watched data point at year-end is stubbornly high annual inflation year-over-year. While we have previously cautioned against the base effects of comparing prices this year to those of 2020 during the pandemic, it is becoming more obvious that pandemic-related supply chain effects and monetary policy decisions have led to a more persistent inflationary environment. The chart below reflects the path of the CPI before, during and after the pandemic:



Compared to one-year ago, prices are up nearly 7% on average. This is due to a combination of 1) supply-chain disruptions leading to a scarcity of some goods, caused in part by the COVID-19 pandemic, 2) the typical pattern of consumer demand preceding business inventory capacity to meet such demand, which has been distorted in the extreme by pent-up demand after unprecedented government

lockdowns last year and 3) crisis-era monetary policy for much of the past 10+ years that has pumped unprecedented liquidity into the financial system. While we believe the first two causes will be alleviated naturally as the pandemic eventually subsides, the long-lasting effect of crisis-era monetary policy needs to be addressed by the Federal Reserve. To this end, the Fed announced in December a tightening of monetary policy through "tapering" or reducing the amount of treasuries and mortgage-backed securities that it purchases each month to the point of eliminating the purchases by early 2023. Additionally, the Fed now projects three interest rate hikes in 2022 with an additional three more increases in 2023. The delicate balance necessitated by the urgency of getting a handle on inflation, while also supporting the economy in the event of COVID related economic shocks, is imperative for the Fed to execute as we head into 2022.

On Black Friday, markets sank on the emergence of the latest Omicron COVID-19 variant. Omicron has quickly become a prevalent strain of the virus in the U.S., U.K., South Africa and elsewhere. While some reports indicate infections are less severe with Omicron, it appears to be more contagious and therefore could cause some degree of strain on the hospital system just due to the large number of infections. While COVID is clearly something to take seriously from a public health standpoint, we feel that from an economic and investment standpoint, the non-pharmaceutical interventions taken by politicians and government authorities to stem outbreaks appear to do the most damage. As we noted above, most businesses have adapted to the point of sustainable (if not lower) profitability, despite the waves of virus caseloads, by utilizing remote work from home technologies. Over 70% of American adults have been vaccinated against the virus and many Americans are still resolute in going about their daily lives regardless of vaccination status.

Nevertheless, markets have continued to react in knee-jerk fashion to COVID trends on the premise that more cases lead to more hospitalizations and deaths, which in turn leads to more lockdowns and lower economic activity. Part of the market volatility in December is attributable to a belief that the latest COVID trends will lead to economically harmful public health measures. We believe this causation will eventually be broken as COVID becomes a long-lasting endemic virus around the world. Increased immunity from infection, vaccinations and, most importantly, effective treatments to prevent infected people from becoming severely ill (such as with the recent Pfizer and Merck oral medications), will eventually break the chain of infection to hospitalization to death for most people, thereby eliminating the need for lockdowns. This has already been seen with the omicron variant – for example, South Africa is seeing 30% fewer hospitalizations in proportion to cases and 80% fewer ICU admissions in proportion to cases from omicron than with prior strains. Our hope and expectation are that this trend of less severe outcomes will continue with each subsequent strain of the virus.

Looking Ahead to 2022

Heading into 2022, we are cautiously optimistic that equities are set up to continue on a strong 2021 with continued earnings growth as the economy re-opens more fully, hiring and inflation data improve, and COVID becomes less dominant in our everyday lives and the economy. However, due to the potential for uncontrollable and unforeseeable developments in COVID cases and the response of governments globally, we will have to remain cautious in investment allocations, particularly for those investors in or near retirement. If significant unforeseen events, like widespread government shutdowns, that chill economic activity were to occur, the potential for "stagflation", a stagnant economy combined with high inflation, cannot be discounted. Later in the year, politics will again take center stage with the mid-term Congressional elections.

The consensus analyst estimate for 2022 S&P 500 earnings is approximately $222.32. While cognizant of the fact that analysts' estimates tend to overshoot the actual earnings achieved and applying an above average market P/E of 22-25 (less than the current S&P 500 multiple of 27) implies a mid-teens market return for 2022. Again, trends in COVID caseloads will weigh heavily on returns achieved and expected market volatility will cause us to approach investor allocations with more caution next year.

Importantly, a rising interest rate environment in 2022 and beyond will have implications for investor allocations. Within equities, financials are a clear beneficiary of a higher interest rate environment through banks' greater net interest margins. Additionally, higher inflation promotes higher asset prices across the spectrum, including equities, but most heavily those equities with sensitivity to hard assets like the energy and materials sectors. Our firm portfolio has overweight exposures in these stock sectors. High quality businesses with strong pricing power that are able to pass along input price increases will also stand to out-perform in an inflationary environment. Overall, a continued economic rebound from the COVID pandemic shock will benefit cyclical/value stocks in the market, assuming no additional government lockdowns.

As interest rates rise in the near-term, we believe there will be increasingly more attractive opportunities within fixed income and credit strategies than there have been in the recent low-rate environment. For those investors in retirement, the low interest monetary policy of the past 10+ years has been especially punitive. We expect conditions to improve such that investors will not need to take as much default risk in their fixed income allocations nor rely on strategies employing high leverage to improve their yields.

As usual, all comments are welcome and appreciated.