2021 MARKET REVIEW

In 2021, financial markets exhibited many of the same trends that first began in the second half of 2020. The pandemic induced recession, and recovery that followed, was much more akin to a natural disaster than the Global Financial Crisis in 2008, due in part to the cause of the downturn as well as the magnitude and pace of the policy response. Though our everyday lives still feel far from "normal", markets are operating as expected in many asset classes and sectors, given the broad economic expansion we are experiencing. While much of the global equity market increased year over year, fixed income markets struggled as interest rates rose, commodity prices rose, and inflation spiked well above expectations. Despite the S&P 500 closing at an all-time-high on 70 separate occasions this past year, and registering a maximum drawdown of only -5% (compared with -34% in 2020), it has felt like financial markets have exhibited much higher levels of volatility than the headline numbers would imply. This is driven by the construct of market cap weighted indices where wild swings in prices have been centered around companies that have lower weightings. Also, the bigger picture is being skewed by the financial media's quest for better ratings, as there tends to be a focus on select pockets of the market, such as cryptocurrencies, meme stocks, and SPACs, where irrational expectations of future returns have led to extreme levels of volatility.

	12/31/2021 Level	QTD Change	YTD Change
S&P 500	$4,766	11.00%	28.70%
MSCI ACWI Ex USA	$299	1.80%	7.80%
MSCI Emerging Markets	$608	-1.30%	-2.50%
Bloomberg US Aggregate	$2,355	0.00%	-1.50%
10 Year Treasury Rate	1.52%	0 BP	+59 BP
Bloomberg Commodity Index	$99	-1.60%	27.10%
Bitcoin	$47,192	13.50%	60.60%

While the global pandemic raged on in 2021, there were many noteworthy events that impacted our lives and affected capital markets including: riots at the US Capitol, deadly and destructive weather across the globe, shipping and supply chain issues, an increase in cyber security threats, the introduction of space tourism, housing booms (US) and busts (China), and changing geopolitical and policy environments. All of these events or themes were in some way further impacted by the pandemic, or the outcomes of which were further exacerbated by the decisions politicians made to protect the wellbeing of the general public. We are going to discuss a handful of topics that we think explain how and why markets behaved the way they did in 2021 and that shed some light on where we go from here.

Global equity markets have had to deal with a multi-year pandemic and record levels of inflation, amongst other tail risks, and have continued to march higher. The outlook for multi-asset portfolios does not get any easier from here. Central bank policy is moving towards normalization with shrinking balance sheets and higher rates, which most directly affects bond prices, but also impacts equity valuations. The environment over the past 20 months has rewarded investors for taking on higher levels of risk, however, we do think that disciplined asset allocation and security selection decisions will need to be emphasized in 2022. While it is difficult to forecast market movements on a short term basis, it is widely expected that the next 10 years will produce lower returns than the past 10 years, but with yields on cash and fixed income where they are, money should continue to flow into equity markets. Strong earnings, coupled with equity market inflows, should propel equities mildly higher despite expensive valuations.

Fiscal & Monetary Policy Decisions:

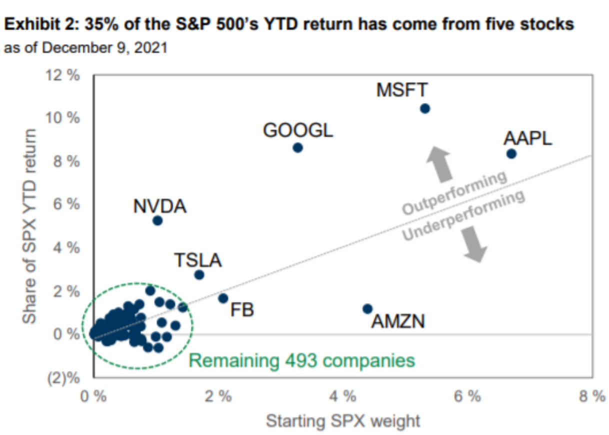
Policy decisions made in 2021 will have lasting impacts on all major economies in 2022 and beyond. Central banks around the world have been faced with record high levels of inflation, that has accelerated towards yearend. As we discussed last month, the US Fed has already embarked on a journey towards normalization that will include a tapering of the Fed's balance sheet in early 2022 and the potential for interest rate hikes. Many central banks have already raised interest rates to combat higher inflation including the UK and many developing nations outside of Asia. Inflation negatively impacts assets with steady streams of income (bonds) more than assets that offer returns in the form of capital growth (equities). On the fiscal policy side, the Chinese Communist Party made headlines with an increase in rhetoric around their goal to achieve "common prosperity".

Source: MRB Partners

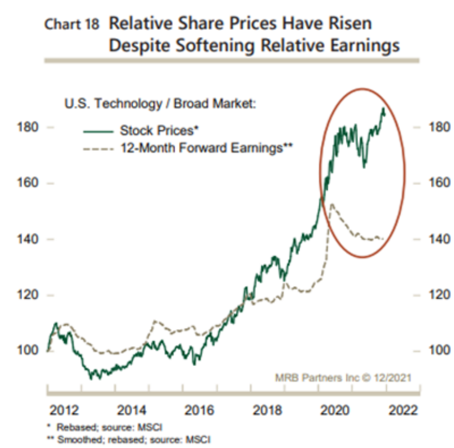
Our understanding of "common prosperity" is that the Chinese government would like to make society more equitable without killing innovation, a difficult task to accomplish. This has resulted in the government stepping in to curtail excesses in industries such as technology, real estate, and online education. Certain companies, including eCommerce giant Alibaba, and property developer Evergrande, have been at the forefront of the government's ire, sending share prices lower. There are clear legislative and regulatory issues in China, but we continue to advocate for a small, actively managed, allocation in a global equity portfolio, as it is difficult to ignore the innovation that can come out of an economy of this scale.

Technology is Eating the World:

In 2011, one of the great founders and investors of our generation, Marc Andreessen, penned an article titled "Why Software Is Eating The World", which encourages investment into the software industry. Following Mr. Andreessen's advice would have resulted in massive gains over the past decade. In hindsight, Mr. Andreessen could have projected success within the entire technology sector. After years of technology sector outperformance, 2021 was projected to bring about an equity market rotation, during which so-called "value" sectors outperform their "growth" counterparts. While certain "value" sectors did recover and outperform the broader market, mega-cap technology companies continued their strong performance as well. The US technology sector returned 35% during 2021, relative to the S&P 500 which returned 29%. However, technology was not the best performing sector, as energy and real estate returned 55% and 46%, respectively. Yet, technology's sheer size relative to other sectors means that the gains in this sector have an outsized impact on the overall market. Another way to think about this is a term called "breadth" which measures the dispersion of returns across a market. For an index with approximately 500 constituents, 33% of the S&P 500's returns for 2021 came from only 5 stocks; Tesla, Nvidia, Alphabet, Microsoft, and Apple. The market's returns through April were extremely broad, per Goldman Sachs, however that breadth narrowed considerably over the past 8 months coinciding with strong gains from those tech stocks noted above. Technology's outperformance can be explained by the fundamental strength that the majority of the sector exhibits through strong balance sheets, growing earnings, and pandemic-proof business models (Tesla excluded). This sector's performance has tended to track earnings expectations higher. Unfortunately this relationship has decoupled, which leaves technology vulnerable to a short-term pullback. On a longer-term basis, we are optimistic technology can continue to perform well, however, the returns will most likely exhibit higher levels of volatility than seen over the last 5 years. It is also important to think about where to allocate within the sector – we tend to favor companies that offer attractive valuations and current free cash flow generation relative to those companies with expectations of massive growth and that trade at nosebleed valuations.



Source: Goldman Sachs Global Investment Research



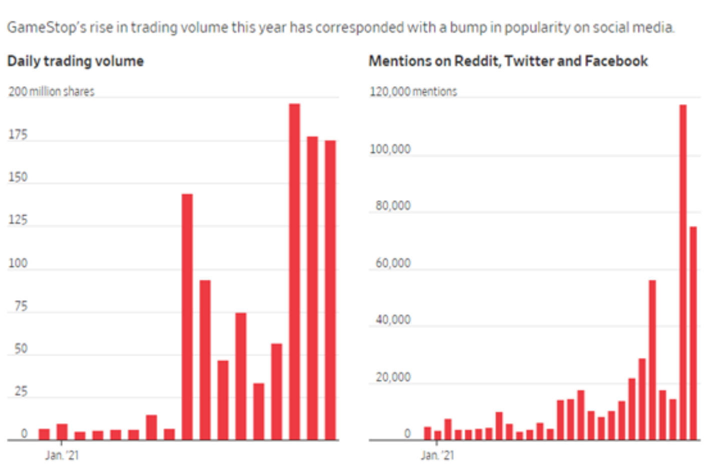
Source: MRB Partners

"Great Resignation" & Housing:

One major theme over the past two years has been the uptick in resignations. Millions of people have quit their jobs to either move to a higher paying job with another company, or have begun working for themselves. The rationale behind this mass exodus is understandable – a lack of resources provided to people stuck working from their dining room table, no separation between work-life and home-life, the increasing cost of many everyday purchases, and the promise of higher wages elsewhere. The numbers are staggering; nearly 3% of the US workforce resigned in October alone while over 500,000 people have begun to work for themselves since the start of the pandemic. Unsurprisingly, many companies are introducing hybrid work models to balance work from home and time in the office. Given the amount of time we are now spending in our homes, many have begun to reevaluate their housing needs; more space, different layouts, and better technology, just to name a few. Even prior to the pandemic, there was an expectation that home prices would continue to rise, given the lack of inventory of new construction, low interest rates, and changing demographics - the pandemic has accelerated these trends in a massive way. House prices have increased double digits across 20 major US cities over the past year, and in some cities (Phoenix for example) prices have increased approximately 30%. Low mortgage rates are helpful but rising input costs and home prices are putting many neighborhoods out of reach for the middle class. Barring a recession, higher mortgage rates over the next 24 months should keep affordability metrics low, while demand remains high. Theories depicting the death of major cities have not proven true, and there is no way replicate the employment and recreational opportunities that major metropolitan cities have to offer, especially to those early in their career.

Meme-stock and Crypto mania:

What would a 2021 review be without mentioning cryptos and meme-stocks? With the majority of people around the world stuck at home and flush with cash from government stimulus packages, many turned to the financial markets for the first time to try their hand at "investing". As most traditional sources of entertainment had disappeared during the pandemic, more and more people began to replace the enjoyment of going to a movie theater, bar, or restaurant with actively trading risky stocks and cryptocurrencies. 2020 was a banner year for brokerage firms like Robinhood and Charles Schwab as Americans opened more than 10 million new accounts; the most in any year in history. This trend did not slow down in 2021, as Charles Schwab alone added 6 million new accounts in the first three quarters of the year. The two stocks that garnered the most attention from these new investors were GameStop and AMC; both of which had been hit hard due to lockdowns and were on the verge of collapse. With inexpensive access to trade stock options, investors gambled on GameStop, which began the year trading under $20. Before the end of January, the stock had surged to a high of $483, with no fundamental catalyst, other than chatter on blogs, such as Reddit. These moves certainly minted new millionaires who bet on GameStop and AMC to rise, but many others lost all of their investment. Some institutional investors were caught shorting (or betting against) various meme stocks and lost billions of their investors' dollars in the process. The fallout from the meteoric rise of a handful of small companies led to congressional hearings centered around the relationships between brokerage firms who provide "free" trading and their counterparts who facilitate the execution of trades in a process called "Payment for Order Flow" (PFOF). PFOF allows one financial firm to compensate another for the ability to process retail trades and is a source of revenue for those firms offering free trading services. These relationships cause conflicts of interest that many are unaware of. Ultimately, investors should understand that there is an implicit cost of trading despite the existence of commission free platforms such as Robinhood. We think there is a high likelihood that these manias will continue to occur, but may be centered on a subset of securities, or types of assets (NFTs), rather than the whole market.



Source: Dow Jones Market Data, Meltwater, The Wall Street Journal