

Investment Review & Outlook

2021 Year-End Investment Market Report

We've been seeing a lot of cartoons and jokes lately about how it has felt like Groundhog Day, with 2021 being basically a repeat of 2020. The reference, of course is to the Covid pandemic, which raged through 2020 and then, when we all expected a return to normalcy, once again peaked (twice) during 2021 and continues to spread in record numbers. But the Groundhog Day analogy could just as easily be applied to the investment markets.

A breakdown shows that just about every U.S. investment asset was up strongly for the second year in a row. Looking at large cap stocks, the widely-quoted S&P 500 Index of large company stocks gained 10.65% during the year's final quarter and overall finished up 26.89% in calendar 2021.

Small cap stocks, represented by Russell 2000 Small-Cap Index, posted a 14.82% gain in the past 12 months. The technology-heavy Nasdaq Composite Index gained 8.28% in the final three months of the year, to finish with a total return of 21.39%.

The foreign markets were not quite so generous to investors. The broad-based EAFE Index of companies in developed foreign economies gained 2.40% in the final quarter of 2021, to finish up 8.26% in dollar terms for the year just ended. Emerging market stocks of less developed countries, as represented by the EAFE EM Index, lost 4.59% in dollar terms in the year.

Other investment categories produced some phenomenal gains, albeit for small portions of most investment portfolios. Real estate, as measured by the Wilshire U.S. REIT Index, posted a 17.14% gain during the year's final quarter, finishing a strong recovery year up 46.18% after a 7.90% loss in 2020. The S&P GSCI Index, which measures commodities returns, gained 1.51% in the 4th quarter, but ended the year up 40.35%.

In the bond markets, yields on 10-year Treasury bonds rose modestly during the year, from 0.95% a year ago to 1.51% currently. 30-year government bonds are yielding just 1.88%. Five-year municipal bonds are providing, on average, a meager 0.60% yield, while 30-year munis are yielding 1.54% on average.

By all accounts, we are in an extraordinary period of investment history. The markets, as measured by the S&P 500 Index, have now doubled since New Year's 2018, and it is hard to find three years to match the three-year record of 28.88% (2019), 16.26% (2020) and 26.89% (2021) returns that index investors have enjoyed during this remarkable stretch. The widely-quoted proxy for U.S. market returns closed at a record level 69 times in the past 12 months, which is a recipe for spoiled investors to expect more of the same. Yet few would suggest that stocks are cheap at the moment; by one measure, the Price/Earnings ratio of the S&P 500 Index is just over 30, which is about 70% above the modern-era market average of 19.6.

With interest rates and bond yields at rock bottom, investors seem to have decided that stocks are the only way to make money in their investment portfolios. But the current valuations suggest that high returns won't last forever, even if there are few warning signs on the economic horizon. One concern is inflation, which has spiked over the last 12 months to levels not seen since the old "stagflation" days of the 1980s. But if we look at the health of the economy, the U.S. real gross domestic product has largely recovered its former trajectory after a steep decline in the spring months of 2020. The unemployment rate is moving steadily down toward the record lows that the economy had reached before Covid reared its ugly head, and the U.S. payroll numbers are clearly on the rise as well. Growth forecasts for the fourth quarter of 2021 range as high as a 7.5% annualized rate, which is about as bullish a report as you will ever hear from the normally sober crowd of professional economists.

It is possible to wonder whether companies will be able to maintain their rising profit margin trajectory with the shortage of workers and the resulting higher salaries throughout the economy. Unit labor costs rose a remarkable 9.6% in the third quarter of 2021 (the most recent statistics we have), and productivity (which is a function of the cost of labor) accordingly dropped 5.2%. In manufacturing, unit labor costs were up 4.6% and productivity decreased 1.8%.

Another worry is whether the U.S. central bank's promise to reduce its stimulus measures in 2022 will cause interest rates to rise. Some economists believe that a global glut of saved cash will lead to a demand for longer-term bonds; by the laws of supply and demand, this could keep 10-year yields at or below 2% in the coming year. But these are tricky predictions; it is possible that bond investors will be able to demand higher yields once they are no longer negotiating against the Federal Reserve Board's unlimited deep pockets and indifference to returns.

Meanwhile, who knows what to expect from the wild cards that have so far had little impact on our financial landscape? Covid is peaking again, with the new Omicron variant creating the largest spike in the pandemic to date; nobody knows what the economic impact will be when the final measurement comes back a few months hence. Billions of dollars are locked up in various cryptocurrencies (there are more than 700 of them currently), and the recent severe price downturn might cause some investors to cash out of their stock portfolios. Meme stocks are still trading at crazy valuations, which so far have had little impact on the broader market, and there are continuing worries about supply chain disruptions and the future health of the Chinese economy.

This is a long way of saying that the signs are mixed going into 2022, but when has it been otherwise? If there's one lesson for us to take from this long, extended period of market prosperity, it is that the future is unknown, and the surprises more often favor the upside than the downside. The markets will certainly pull back at some point, but that prediction has been made for each of the years that have contributed to the recent 100% growth in stock values. A steady course has been surprisingly beneficial to investors in the face of many worries, but perhaps we shouldn't be surprised, since that has always, long-term, been the winning investment strategy.

If your financial situation has changed, please let us know. Please reach out with any questions you may have.

The FAM Team