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Market Outlook & Strategy

Fourth Quarter of 2021

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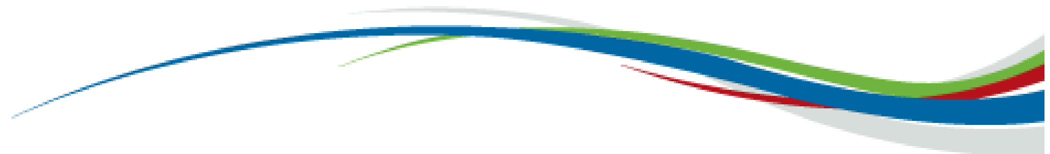

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Executive Summary

- **Fourth quarter**. Financial markets turned in a very strong fourth quarter after a disappointing Q3 result. Returns were boosted by investors looking past the Covid-19 Delta variant and consumers resuming normal activities. Global market returns increased by +6.1% in Q4, with the U.S. market leading the way at +11.0%. Other major markets did not fare so well – international markets posted +3.1% and emerging markets declined by -0.5%.

- Almost all bond returns were flat during the quarter, with the exception of TIPS (Treasury inflation-protected securities), which increased by +2.4%. Municipal bonds also posted a positive return of +0.7%.

- **2021 summary.** It was another great year for stock investors. The global equity market advanced by +18.2% overall, with U.S. stocks leading the way, increasing by +25% and capping their third year in a row of double-digit gains. Commercial real estate also had a good year up +31%, followed by commodities at +27.1%.

- In sharp contrast, technology disruption stocks came back to earth in 2021, especially the healthcare-related plays. Emerging market equities also suffered, in part due to China's regulatory crackdown on a few key sectors of the economy, relatively low vaccination rates, and zero-tolerance policies against Covid infections in some of the Asian emerging markets. Fixed income returns varied, but overall it was hardly the bloodbath many analysts predicted, and many segments outperformed cash.

- **2022 outlook.** Our outlook for 2022 is for continued but moderating growth in global economies and equity returns. Taming inflation will be the key challenge and Federal Reserve actions (or inaction) will be key to the ultimate results. But the global economic environment is still strong, and if we don't get slammed by another Covid variant, we ought to see mid-single digit returns in U.S. equities.

- **Artemis strategy.** Given current risks, we are maintaining a more balanced allocation between growth and value, trimming our technology disruption holdings on a tactical basis, modestly increasing international exposure, and planning to continue to play it safe with fixed income.

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Q4 and Year in Review

Financial markets in the developed world turned in a very strong fourth quarter after a disappointing Q3 performance. Returns were boosted by investors seeing past the Covid-19 Delta variant and consumers resuming some healthy spending. In the U.S, healthy job growth and stellar corporate earnings also encouraged investors. In the aggregate, global markets increased by +6.1% in Q4, with the U.S. market leading the way at +11.0%. See Figure 1. Other major markets did not fare so well – international markets posted +3.1% and emerging markets declined by -0.5%.

Figure 1. Asset Class Returns in USD for 2021 (%)*

	2021					
Asset Class	**Q1**	**Q2**	**Q3**	**Q4**	**Total Year**	**Index**
Equities						
All Markets - Global*	5.1	7.2	(1.1)	6.1	18.2	MSCI ACWI IMI (net)
U.S. Large Companies	6.2	10.4	0.6	11.0	28.7	S&P 500
U.S. Small Companies	12.7	4.3	(4.4)	2.1	14.8	Russell 2000
U.S. Growth	2.1	12.0	1.9	11.6	27.3	Russell 1000 Growth
U.S. Value	10.8	5.0	(0.9)	7.6	24.4	Russell 1000 Value
Tech Disruptors	1.0	6.1	(5.5)	(2.5)	(1.0)	Equal weight: XT, CIBR, SKYY, XBI, ARKG, ARKQ
Int'l Developed Markets	4.0	5.6	(0.7)	3.1	12.6	MSCI EAFE & Canada (net)
Emerging Markets	3.1	5.7	(6.5)	(0.5)	1.4	FTSE EM All Cap China A Inclusion (net)
Fixed Income						
All Segments - U.S.*	(3.4)	1.8	0.1	0.0	(1.5)	Barclay's U.S. Aggregate
U.S. Treasuries	(5.8)	2.4	(0.2)	0.4	(3.1)	Merrill Lynch U.S. Treasuries, 7-10 Years
U.S. Municipal Bonds*	(0.3)	0.9	(0.1)	0.4	0.9	Barclay's Municipal Bonds, 1-15 Years
U.S. Corporate *	(2.5)	0.4	0.2	(0.8)	(1.1)	Merrill Lynch U.S. Corporate Bond, 5-7 Years
U.S. High Yield	0.9	2.8	0.9	0.7	5.4	Merrill Lynch U.S. High Yield Bond
Int'l Bonds	(6.5)	0.3	(1.8)	(1.9)	(9.7)	Merrill Lynch World Gov't Bond, Ex-U.S.
EM Bonds*	(5.3)	4.5	(0.8)	(0.2)	(2.1)	J.P. Morgan USD Emerging Market Bonds
Floating Rate Bonds	1.0	1.1	1.0	0.4	3.5	S&P.LSTA U.S. Leveraged Loan 100 Index
Real Assets						
U.S. Tips	(1.5)	3.3	1.8	2.4	6.0	Barclays Capital U.S. TIPS
Commodities	6.9	13.3	6.6	(1.6)	27.1	iPath Bloomberg Commodity
U.S. Real Estate Income*	1.5	4.9	0.2	2.8	9.9	Fidelity Series Real Estate Income Composite
Global Real Estate - REITS	6.5	10.4	0.1	11.8	30.7	S&P Global REIT TR

*Used to create Artemis portfolio benchmarks
* Benchmarks were S&P 500 Growth and Value prior to Q4

The bond market continued to perform as if inflation was transitory, with the yield on the 10-year Treasury ending the year at 1.5%, barely budging during the quarter. Almost all bond returns were flat during the quarter, with the exception of TIPS (Treasury inflation-protected securities), which increased by +2.4%. Municipal bonds also posted a positive return of +0.7%.

The steady performance of the bond market was unusual, given that the one-year U.S. inflation rate through November 2021 was 6.8%, its highest rate since 1982.

Year in Review

While it was a terrific year overall for stock market investors, it is hard to argue that it was a good year for much else. We started the year with an insurrection no less, cheered up when we all thought Covid might be nearing an end, only to suffer through the Delta variant during the summer and a fair bit of hand-wringing over the sudden appearance of inflation. We then ended the year all trying to correctly pronounce the name of yet another new Covid variant. In the meantime, the culture wars in the U.S. only got worse, Russia's President Vladimir Putin amassed his army on the Ukrainian border, and China surprised us all with a major regulatory crackdown.

But despite all the glum political and coronavirus news, much of the economic news was nothing short of stellar, with most major global economies (except China) posting their fastest growth in nearly 50 years. In the U.S., corporate profits surprised strongly to the upside, due in large part to margin expansion, demonstrating that companies were largely able to pass on the sharp increases in prices across the supply chain. As a result, the global equity market advanced by +18.2% overall, with U.S. stocks leading the way, increasing by +25%, and capping their third year in a row of double-digit gains. Commercial real estate also had a good year, up +31%, followed by commodities at +27.1%.

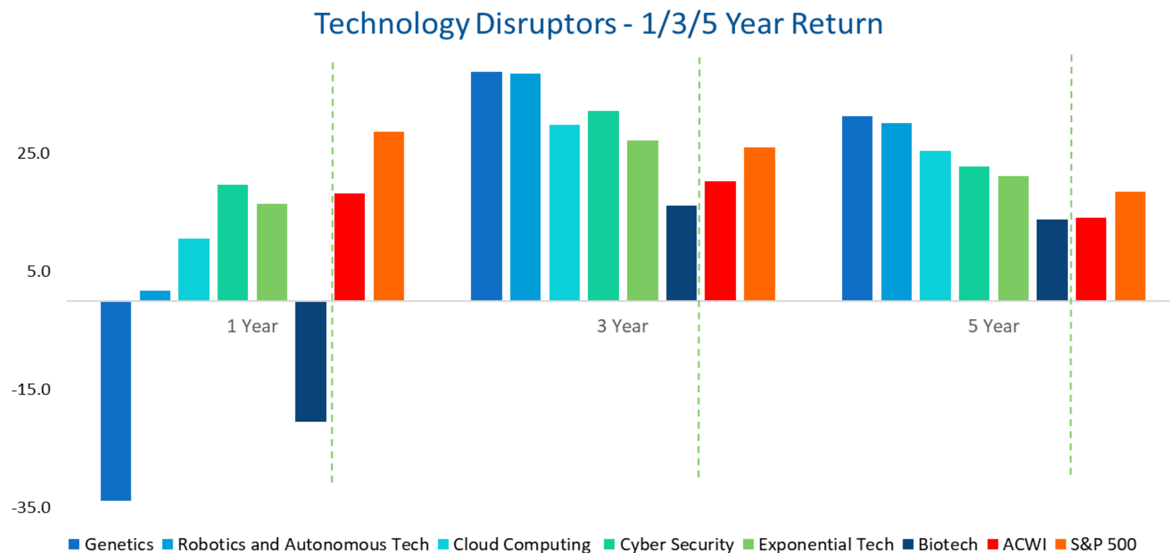
But it was not all good beneath the surface as many stocks were left behind. For example, 10% of S&P 500 stocks and fully 60% of NASDAQ Composite stocks ended the year at least 25% below their 2021 highs. In addition, five of the biggest stocks in the S&P 500 accounted for more than half of the broad benchmark's gain since April and were collectively responsible for around one-third of the overall advance of the +29% gain in the S&P 500 for the year.

We also witnessed some truly bubbly activity and all learned what 'meme' stock means. AMC Entertainment Holdings stock rose more than tenfold; GameStop stock, the poster child for so-called 'meme' stocks, increased +700%; and Tesla once again defied the odds by

gaining almost $200 billion in market value within four days in late December – more than the equivalent of Ford Motor and General Motors combined. In a similar vein, cryptocurrency went mainstream in 2021, touted by Tesla founder Elon Musk and becoming available to purchase in an ETF (exchange-traded fund) format.

In sharp contrast, technology disruption stocks came back to earth in 2021, especially the healthcare-related plays. Cathie Wood's ARK Innovation EFT (ARKK) fell more than 23% during the year, in a sharp reversal of fortunes from its meteoric 150% gain in 2020. An equal weighting of the six areas Artemis is invested in returned a disappointing -1.0% during the year, but clearly our very broad diversification helped.

Figure 2. Technology Disruption Trailing Returns



Emerging market equities also had a horrible year, in part due to China's regulatory crackdown on a few key sectors of the economy, relatively low vaccination rates, and zero-tolerance against Covid infections in some of the Asian emerging markets. Emerging market returns were also negatively affected by dollar strength in 2021, which increased the cost of servicing emerging market debt denominated in dollars. For all of these reasons, emerging market equities returned a disappointing +1.0% for the year.

Fixed income returns for 2021 varied quite a bit, but apart from international bonds (due to the strong appreciation of the dollar in 2021) and U.S. Treasuries, it was hardly the bloodbath many analysts predicted. Indeed, our own custom benchmark, reflecting the

current segments of the market we are invested in, returned +0.6% during the year, thanks to strong positive returns in real estate income, TIPS, and a lower but still positive return in municipal bonds. And many of our clients did much better, thanks to some incredible outperformance in the particular real estate income fund we utilize. In short, (the right kind) of fixed income returned more than cash did, on average.

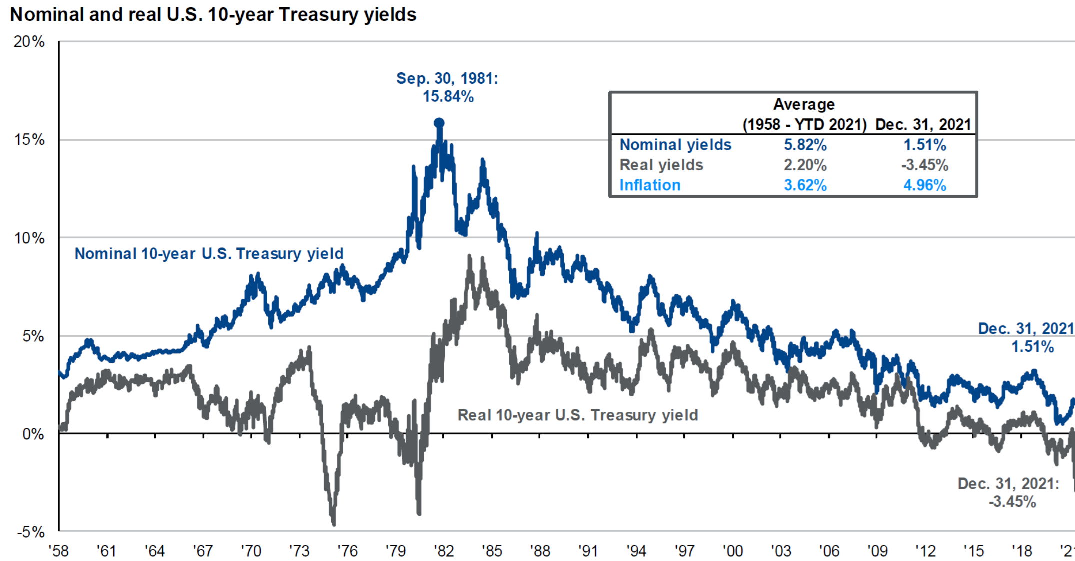
A key theme for 2021 was the resurgence in inflation. For December 2020 through November 2021, inflation reached 6.8%, its highest in almost 40 years. Much has been written about whether this bout of inflation is largely due to excess overall demand, or a demand shift towards goods versus services that has led to severe supply disruptions. (The implication is that if inflation is due to a generalized increase in demand, it's going to be with us for some time.) As 2021 came to a close, there seemed to be a shift in the Federal Reserve's thinking away from the view that inflation is purely transitory. As a result, the Fed announced plans in December to accelerate the end of its bond-buying program and now expects to raise short-term interest rates three or possibly four times in 2022.

Despite the Fed's change in stance, the bond market did not seem to believe that inflation was going to stick around as the long end of the Treasury yield curve remained anchored. By year end, the yield on the 10-year Treasury bond was only 1.5%, leading to real interest rates falling to levels not seen since the late 1970s. See Figure 3 (next page). Negative real interest rates are a key reason why equity and real estate markets are faring so well.

2022 Outlook

As we begin 2022, vaccine distribution, additional fiscal support, and continued easy money will all help to drive a global economic recovery. Building on another year of soundly positive market returns and corporate profits, the global economic backdrop continues to be strong. Yet in the near-term we are confronting an unpredictable brew of geopolitical and economic uncertainties that threaten to create commotion in 2022. We believe the convergence of potential challenges amid a healthy economic "mid-cycle" environment will result in global equities delivering mid-single digit returns next year, but the ride will be bumpy.

Figure 3. Interest Rates and Inflation

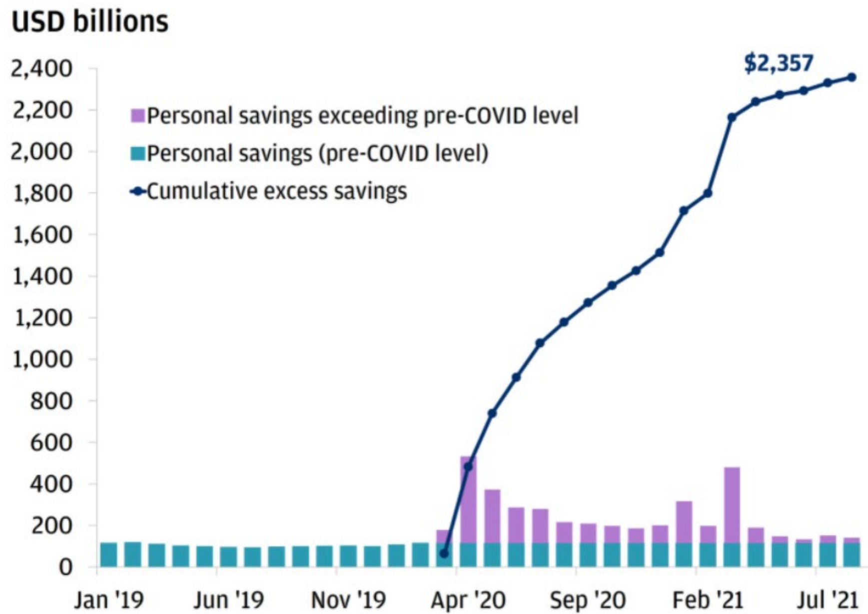


The Positives

We still see no signs of a recession or bear market on the horizon. Activity is healthy, the global economy is projected to continue to grow above-trend, and in the U.S. especially, excess consumer savings and the strong labor market will continue to support robust consumer demand. Excess consumer savings is a key metric we are watching, and while the rate of savings has begun to normalize (purple bars below in Figure 4), there is still $2.35 trillion of 'dry powder' to work its way into the economy over the next few years.

Corporate profits were very strong in 2021, and they are expected to continue to be above trend in 2022, with earnings projected to grow at +9.2% and revenue growth projected at +7.5% (FactSet). These are strong growth projections versus the 10-year averages of +5% earnings growth and +3.5% revenue growth from 2011-2020.

Figure 4. U.S. Personal Savings Trends



Our base case for the Federal Reserve and central banks globally is that they will be gradually less accommodative, with asset purchases winding down and interest rates rising. This, in many ways, is a good thing because it means the economy is on better footing and that the drastic measures taken during the pandemic can start to be unwound. The challenge is that markets have become addicted to cheap money, and any change can be disruptive, especially if this happens more quickly than expected – more on this in the 'Risks' section below.

Smaller companies look poised to benefit in 2022 from easing supply chain pressures, robust economic activity, and compelling relative valuations. In terms of pure valuation, the S&P small-company index is at its greatest relative discount to the S&P 500 since the late 1990s. This is in part due to the outsized impact of the FAANG stocks in recent years, but also because smaller companies have had an outsized negative impact from Covid restrictions and supply chain bottlenecks. Smaller companies also tend to perform well in periods of economic growth and rising interest rates. (The largest segment in the U.S. small company index is financial services, which tend to do well when the economy is expanding and interest rates are rising.)

As for emerging markets, we would not be surprised if the U.S. dollar continued to be strong in 2022, due to U.S. economic strength alongside the potential for rising interest rates. This would be a negative for emerging markets, particularly those countries already challenged by Covid that haven't been able to rely on a government backstop.

Regarding China, the government is already starting to ease due to concerns that it may have gone too far in restricting credit growth and economic activity. If they continue the easing we've seen recently, the Chinese stock market may have a very good year.

Finally, the pandemic has continued to accelerate the trend toward digitization, and corporations and consumers are accelerating their transition to this new world. Although 2021 was a disappointing year for innovation-oriented companies, which overheated in 2020, we continue to believe that this longer-term thesis is intact. Companies that are embracing innovation and disruptive technology, or that are enabling and adapting to such change, are in a powerful position to drive the economy forward over the next decade.

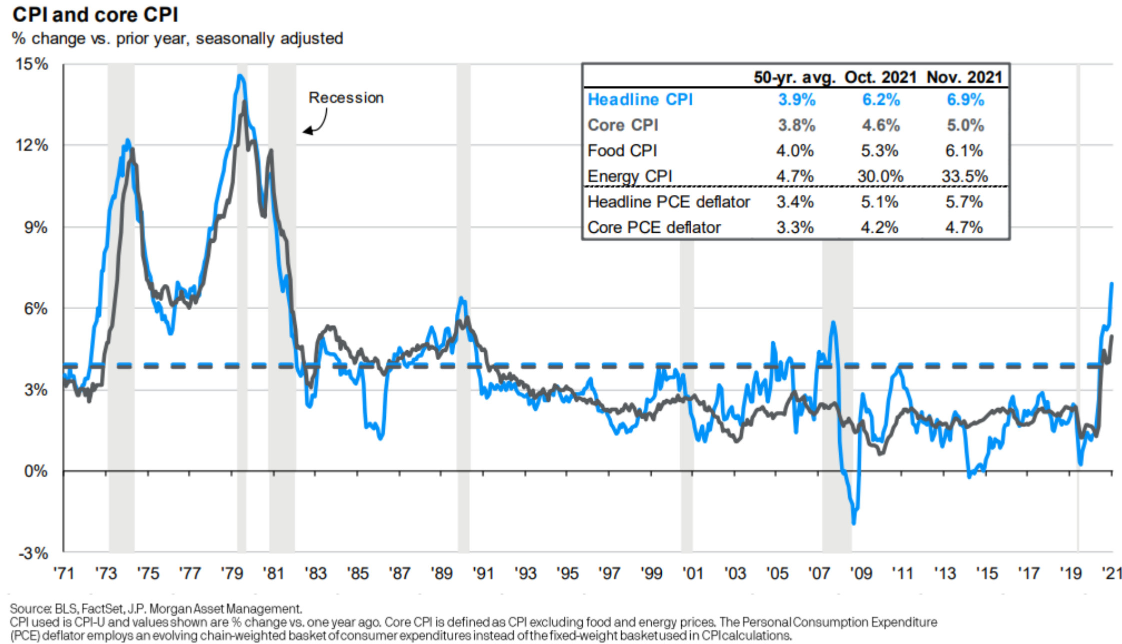
Risks

The key risks for 2022 are how inflation unfolds, whether the Federal Reserve makes a mistake, the rise of yet more Covid variants, and various geopolitical hazards that might also put a stop to the party.

The trajectory of inflation is key because it will drive how much and when the Federal Reserve and other global central banks reduce their support. When rates rise, investors have more options for where to earn a return and could become less willing to take risks. Should the Federal Reserve misread the trajectory of inflation and increase rates more rapidly than needed, the stock market may sell off sharply. Likewise, if inflation is persistent but the Fed does not take timely action, then it may have to raise rates a lot when it finally does start intervening, which, in a worst-case scenario, could cause a recession.

After reaching almost 7% in 2021 (core headline CPI – see Figure 5), the current consensus is that inflation will peak early in 2022 but start to decline thereafter, as supply chain bottlenecks continue to ease and oil production ramps up to meet demand. But few now believe inflation will return to its low pre-pandemic level in the next year or two, largely because wages are expected to rise faster than productivity, and shelter prices continue to increase due to a structural shortage in supply.

Figure 5. U.S. Inflation Trends



Geopolitical risks are also on the rise, with an increasingly belligerent Russia, Chinese policy uncertainty, and rolling Covid outbreaks pressuring already beleaguered emerging economies and adding pressure to political systems and institutions. These are mostly low to medium level risks to financial markets but add an additional element of uncertainty entering 2022.

In summary, we see many positives as we launch into 2022 that support upside economic growth and market action, but many risks that could lead to increased volatility throughout the year. While the road may be bumpy, we remain hopeful for a positive single-digit year for equity returns.

Artemis Portfolio Strategy

Our base case scenario is another year of positive but moderating global growth and corporate profits; inflation slowing to the 3.5% range by year end; interest rates rising but only modestly as inflation eases; and China reflating in advance of its October elections. As we have been emphasizing, the biggest risk to this outlook is that inflation remains high, leading to more robust central bank tightening and adding pressure to financial markets. The other key risk is that fairly strong growth expectations miss or China fails in its efforts to reignite its economy, affecting both China and the global economy from knock-on effects.

Our strategy in 2022 is to balance our exposure to these risks, while maintaining our longer-term outlook and seeking prudent opportunities where we see upside.

Maintain approximate balance between growth and value. Cyclical stocks should outperform growth if interest rates move upward and we don't get any new (dangerous) variants. Yet growth companies with strong cash flow generation and profitability metrics and pricing power will have resilience in an inflationary environment, should inflation remain higher for longer.

Reduce tech disruptors, add to small cap. Technology disruption stocks may suffer if interest rates move up and investors start discounting companies with more distant profit realization. As such, we think it is prudent to trim some of our more speculative exposure until we see how the normalization process unfolds. However, we also plan to bolster our diversified small cap exposure as smaller companies in general are likely to do well in our presumed post-Covid environment.

Modest increase to international markets with a focus on China. There is no escaping the fact that the U.S. equity market has outperformed international markets over the last 14 years. The cyclical nature of stocks tells us that this can't go on forever. As shown in Figure 6 (next page), current U.S. equity outperformance is the longest on record over the last 50 years. While it is near-impossible to predict market leadership changes, higher interest rates favor the more cyclical mix of companies in Europe. This, coupled with the low relative valuation of European and Japanese equities, may set the stage for some outperformance in 2022.

The story in emerging markets is more difficult. In a world in which major developed market central banks are increasing interest rates, many emerging market countries will have to increase interest rates even more to support their currencies and slow capital flight. Sharp interest rate increases will slow economic growth just when they need it most. As discussed earlier in this report, China is in a different position and will more than likely be easing most of 2022, not tightening. As such, and to the extent to which we can in client portfolios, we will be increasing our tilt toward China and its neighbors to, hopefully, benefit from this reflation.

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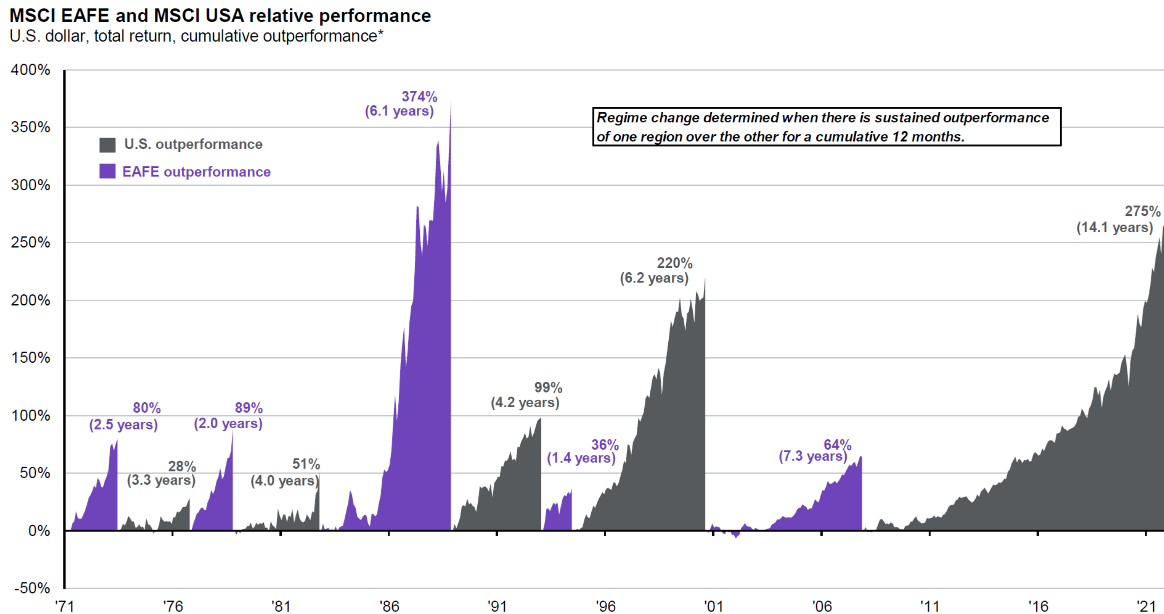
Figure 6. Cycles of U.S. Equity Outperformance



Continue to play it safe in fixed income. Fixed income is not expected to offer much in the way of compensation to investors in 2022, unless one starts to chase yield again. But safe fixed income will continue to serve as ballast in volatile markets. As such, it continues to be our view that it's better to take less risk in fixed income by focusing on very high-quality corporates, (federally insured) mortgage-backed securities and municipal bonds.