Making Sense of Finance

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Fourth Quarter 2021 Review

STOCK MARKET

Domestic stocks finished out 2021 strong with a double-digit percentage gain (11%) recorded by the S&P 500 index in the fourth quarter. Although not to the same degree, other major indexes such as the Nasdaq Composite and the Dow Jones Industrial Average had strong showings last quarter with gains of roughly 8% for each index. The S&P 500 index was driven by solid gains in some of the index's largest components. Apple was the largest contributor to the S&P 500 fourth quarter gain, followed by Microsoft and Tesla. The top five companies in the S&P 500 make up 23% of the index (rounding out the top five are Alphabet and Amazon). The significant gains in stocks for all of 2021 were due to corporate earnings growth since price/earnings multiples declined over the last year (although not in the fourth quarter). An increase in both revenues and profit margins contributed to the rise in earnings. Dividend increases did not keep up with the increase in earnings however, as companies within the S&P 500 paid out the lowest percentage of quarterly earnings in over ten years. The dividend yield on the S&P 500 index is now 1.2% which trails the yield on the 10 Year Treasury. After a sharp sell-off for a few days after the Federal Reserve's December meeting and partially due to a surge in covid cases, the stock market rebounded and finished the quarter and year strong hitting more record highs. The policy statement released by the Fed initially made investors nervous regarding the end of QE, (Quantitative Easing), that is expected to take place early in 2022 as well as the three-to-four interest rate hikes also projected for this year. The Fed thinks it is necessary given rising inflation, which is way above the Federal Reserve's target of 2% on average. However, optimism about continued corporate earnings growth, and TINA (There Is No Alternative, given the extremely low level of interest rates) are propelling stock prices higher.

All stock sectors had positive returns for the last quarter except one, communication services which was slightly negative. REITs (real estate investment trust) and technology were the leaders with gains of over 16% for each group in the fourth quarter. REITs were also the second-best performer for the year, only beat by energy stocks

Making Sense of Finance

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Everyone and their neighbor has an opinion. At Karagosian Financial Services, we have a combined 40 plus years of investment experience. We have seen the markets at their highest highs and lowest lows. Through this newsletter we attempt to convey our opinions on current events in the investment world and their likely outcomes. Forecasting is inherently difficult and our advice is geared toward making sensible and prudent choices based on logic and experience, and not based on emotion.

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which were higher in the fourth quarter but trailed the market. All S&P 500 stock sectors performed well in 2021; even the worst sector performance was an increase of 14%, this sector was utility stocks. Larger cap stocks outperformed their mid and small cap counterparts in the fourth quarter and for all of 2021.

Overseas stock markets did not perform as well as US stocks last quarter. When calculated in local currencies they did better but gains were not as substantial as in the US. The US dollar index (measures the US dollar against a basket of six foreign currencies) appreciated somewhat in the fourth quarter as it had done in all of 2021 which is the reason for the discrepancy between local and US dollar term results. For example, the MSCI EAFE index which is an index of developed countries' markets increased 3.6% in the fourth quarter when measured in local currency terms but only 2.4% when translated into US dollars. European markets in general had larger gains than Asian markets last quarter, led by Switzerland, Sweden, and France. Japanese stocks and Chinese stocks had losses in the fourth quarter. The Emerging market index, which represents less developed countries, struggled and posted a loss for the quarter.

BOND MARKET

Bonds in general were flat in the fourth quarter as measured by the Barclays US Aggregate Bond Index which had a total return of 0.1%. Long term Treasuries outperformed corporate bonds as yields remained the same or declined on Treasuries with maturities of 10 years or longer. The 10 Year Treasury yield ended last quarter where it began at 1.52%. However, the yield curve did flatten as short-term Treasury yields moved up substantially. Yields on a 1 Year Treasury Bill increased from .09% at the start of the fourth quarter to .39% by the end of the quarter. Bond investors were facing the reality of a highly likely increase in the Fed Fund rate in 2022 from its current level of basically zero. Long rates inching lower can be signaling growth concerns in the future. The tapering and the eventual ending of the Fed purchases of Treasuries and agency mortgage-backed securities will take a very large buyer of these securities out of the market. It is difficult to predict how that will affect interest rates this year, and to what extent other buyers will fill that void.

High yield bonds (non-investment grade) again were the leaders in total return in the corporate bond segment last quarter. Treasury Inflation Protected Security bonds also performed better than most other sectors as did municipal bonds given concerns over future tax rates.

OUTLOOK

In the first few weeks of 2022, the markets remain choppy. Still, the S&P500 remains just a few percentage points from its all-time high. Fed rate hikes are undoubtedly coming and already somewhat priced in, however, the timing is what often spooks investors. Though higher interest rates, which will be used to battle higher inflation, will create headwinds for stocks, corporate earnings growth could overcome these obstacles. Our expectation for 2022 stock market returns is tepid, but actual results tend to be uncorrelated from our sentiment.

Rising rates will hurt bonds, but higher rates will also be welcome for retirees and as a more competitive alternative to stocks. Medium to shorter duration bonds (1 to 7 years) are the only reasonable choices, in our view. With the economy still chugging along, we don't see any major credit risk in the near horizon.

Real estate, as an asset class has performed extraordinarily well, in our opinion, given the pandemic and the move to smaller corporate footprints and moratoriums on evictions. Even with the end of shut downs in sight, we would not be surprised if publicly traded REITs underperformed in the next year as it seems positive expectations have already been factored in. In addition, rising rates should put pressure on property values and discourage the current level of borrowing.

We are constantly surprised how a global pandemic has resulted in the stock market appreciating 18% in 2020 and another 28% in 2021. Many companies actually benefitted from the Pandemic. Zoom(ZM) the video conferencing company, for instance, had been public for nearly a year with a flat stock price until the "shut down". Pfizer's (PFE) stock price had been stagnant for half a decade until the demand for a covid vaccine. It will be interesting to see what companies can continue to grow beyond 2022.