

January 2022

2021 Fourth Quarter Update and 2022 Outlook

Review: The S&P 500 finished 2021 with its strongest quarter of the year, up 11.0% in the quarter and 28.7% for the year. The strength was driven by solid corporate earnings and US economic growth. International equities lagged, and developed markets outperformed emerging markets. Fixed income had a lackluster year, with the Barclays Aggregate Bond Index finishing the year in negative territory due to a rise in bond yields in the first quarter.

Period	4Q21	3Q21	2Q21	1Q21	2021
S&P 500	11.0%	0.6%	8.5%	6.2%	28.7%
MSCI EAFE^{1,2}	2.7%	-0.4%	5.4%	3.6%	11.8%
MSCI Emerging Markets²	-1.2%	-8.0%	5.1%	2.3%	-2.2%
Barclays U.S. Aggregate Bond	0.0%	0.1%	1.8%	-3.4%	-1.5%
Barclays Municipal Bond	0.7%	-0.3%	1.4%	-0.4%	1.5%

¹ Europe, Australasia, Far East

² MSCI returns are in U.S. Dollars

2021: Another Strong Year, but What About 2022?

Standard and Poor's currently estimates S&P 500 earnings grew 65% in 2021 and expects another 9% growth in 2022, which would also be above average. The 28.7% return was driven by earnings growth, not by higher valuations. In fact, the market price-to-earnings (P/E) multiple contracted in 2021, from 22.4x to 20.9x. What does this tell us about potential returns for 2022? A third straight year of double-digit equity returns has some investors uneasy, making comparisons to the dot-com bubble of the late '90s. However, current financial market and economic conditions are significantly different than those of the late '90s.

First, prior year returns are not very helpful in thinking about forward year returns, even when prior year returns are very strong (e.g. >25%). As the chart on the following page shows, returns following years with S&P 500 returns >25% have averaged 14.0% since 1950, slightly higher than the 11.7% compounded annual return over the entire period. Additionally, only 18% of the years (3 of 17) had negative returns, similar to the 21% of years over the entire period that had negative returns.

Second, even though the S&P 500 closed out the year near an all-time high, >40% of companies in the index were down >10% from 52-week highs ("correction" territory), and nearly 20% were down >20%.

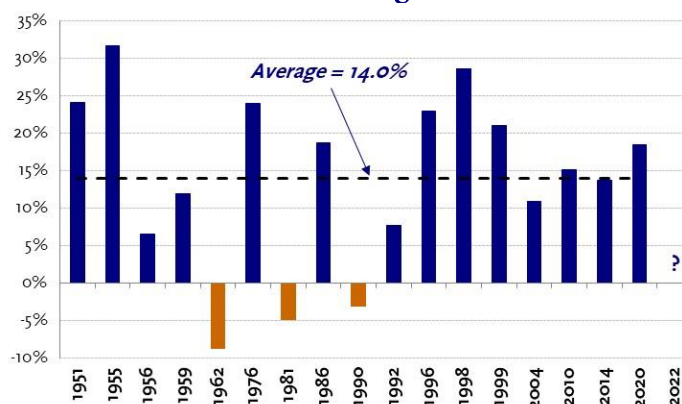
600 Atlantic Avenue
18th Floor
Boston, MA 02210-2211

Phone: 617-357-5101
Toll-free: 800-357-5101
Fax: 617-357-7199

info@middletonco.com
www.middletonco.com

This is rational market behavior in that not all stocks are being bid up. This also reflects investors' desire to stay invested in US equities due to the relative attractiveness of returns versus other asset classes. The dot-com bubble ended during the Fed rate hike cycle of 1999-2000, so the prospect of rate hikes in 2022 is worrying some investors. However, the Fed Funds rate in 1999 averaged 5.0%, so even Treasury bills offered more attractive returns than the S&P 500, which had an earnings yield (inverse of P/E ratio) of 3.8-4.5% in 1999. The current earnings yield is 4.7%, but bond yields are significantly lower—only 1.8% for a 10-year Treasury—and will remain so even if the Fed hikes two to three times in 2022.

S&P 500 Total Returns Following Years with >25% Returns



Source: Bloomberg

Outlook: US economic growth is expected to decelerate after a strong rebound in 2021. The current consensus estimate for real US GDP growth this year is 3.9%, down from the estimated 5.6% for 2021. However, this is still well above the 2.3% average of 2010-19. This should also translate to solid expected earnings growth of 9%, as previously noted, which should support equity markets. US consumer demand remains strong, and overall financial health of consumers appears to be better now than before the pandemic.

International growth will likely remain mixed, partly due to the pandemic and to potential currency headwinds. A rate hike cycle by the Federal Reserve could lead to further strength in the dollar, which could be bearish, particularly for emerging markets.

Potential risks to our near-term outlook include:

- Overly aggressive Fed tightening measures that could impair economic growth more than expected
- Signs of persistently high inflation
- Greater than expected economic impact from COVID variants
- US-China tension

Strategy: Volatility may increase as investors try to anticipate potential moves by the Fed and the resulting impact on corporate earnings and economic growth. We continue to believe that the risk-reward in equities is more attractive than fixed income given our outlook for earnings and view on valuations. The Fed has been very effective at managing policy throughout the pandemic and in its communication, and we believe that this will continue, which should be positive for equities for the time being.