Market Recap

It's been another remarkable year for the S&P 500 Index. Not only did the index of large-cap U.S. stocks return a stunning 28.7%, nearly triple its long-term historical average, but for only the second time in market history, the index reached a new high in each and every month. The strong ongoing performance of large cap tech stocks (formerly shortened to the FAANGs but now, like Covid, with too many variants to keep track of) meant that the S&P 500 also dominated U.S. small-cap stocks (Russell 2000 Index, up 14.8%), developed international stocks (MSCI EAFE Index, up 11.3%), and emerging-market (EM) stocks (MSCI EM Index, down 2.5%) for the year. While the early part of 2021, in the glow of vaccine rollout, suggested that value stocks, small caps and foreign markets would finally play catch up, by the fourth quarter we had reverted to form with the S&P 500 gaining 11.0%, compared to 2.1%, 2.7%, and -1.3% for small caps, developed international stocks, and EM stocks, respectively.

December Benchmark Returns			
	MTD	**QTD**	**YTD**
EQUITY BENCHMARKS			
S&P 500 Index	4.5%	11.0%	28.7%
Russell 1000 Index	4.1%	9.8%	26.5%
Russell 1000 Value Index	6.3%	7.8%	25.2%
Russell 1000 Growth Index	2.1%	11.6%	27.6%
Russell 2000 Index	2.2%	2.1%	14.8%
MSCI U.S. IMI Real Estate Index	9.7%	14.9%	40.6%
MSCI ACWI Index	4.0%	6.7%	18.5%
MSCI EAFE Index	5.1%	2.7%	11.3%
MSCI Emerging Markets Index	1.9%	-1.3%	-2.5%
FIXED-INCOME BENCHMARKS			
Bloomberg U.S. Aggregate Bond Index	-0.3%	0.0%	-1.5%
Bloomberg Municipal 1-15 Year Index	0.1%	0.4%	0.9%
Bloomberg U.S. Treasury TIPS Index	0.3%	2.4%	6.0%
ICE BofA Merrill Lynch U.S. High Yield Cash Pay Index	1.9%	0.7%	5.3%
S&P/LSTA Leveraged Loan Index	0.6%	0.7%	5.2%
ALTERNATIVE BENCHMARKS			
HFRX Global Hedge Fund Index	0.5%	0.1%	3.7%
Bloomberg Commodity Index	3.5%	-1.6%	27.1%
SG Trend Index	0.96	-0.81	9.61
3-Month LIBOR	0.0%	0.0%	0.2%
U.S. Dollar (DXY Index)	-0.4%	1.5%	6.3%

Covid remains the story that won't go away. Just as Americans were emerging from their Thanksgiving food comas, news reports from South Africa reported the latest virus variant with "50 mutations." The news of the since named Omicron variant made the traditionally sleepy day after Thanksgiving a 3% down day and foreshadowed the ongoing struggle with the virus and its management. Other parts of the world, particularly China, are adopting more aggressive approaches to containment that may have significant impact on the global economy in 2022. China's market weakness is the chief reason emerging markets (where China is the 800- pound gorilla) performed so poorly in 2021.

Also contributing to the underperformance of international stocks for U.S.-based investors was the strength in the dollar. After falling early in the year, the U.S. dollar index appreciated sharply, ending the year with a 6.3% gain. A rising dollar is a negative when translating foreign market local-currency returns into U.S. dollar-based returns.

To our minds, the more interesting developments occurred in the bond markets in 2021. The core bond index (Bloomberg US Aggregate Bond Index) lost 1.5% for the year, as interest rates rose displayed sharp volatility and ended the year modestly higher (i.e., the benchmark 10-year Treasury bond yield ended the year at 1.51%, compared to a 0.92% yield at the end of 2020). Given the very sharp rise in inflation, the disconnect between the bond market and inflation is one of the great conundrums as we move into 2022. As you might guess, we place blame at the feet of the Fed for taking over the bond market in a quiet and deliberate fashion. Because the economy was strong, credit markets fared much better than core bonds in 2021. The U.S. high-yield bond index returned 5.4% and the floating-rate loan index gained 5.2%. We expect this trend to continue in the absence of a recession in 2022.

Key Market Drivers

As noted above, large cap US stocks were standout performers in 2021. More particularly, the largest of the large cap stocks led the market higher. If you failed to own those names in the heavy weighting that they came to represent at the end of the year, it was virtually impossible to keep pace. The ten largest stocks in the S&P now make up more than 30% of the value of the index. These names are expensive, although with the exception of Tesla, they all have solid earnings when compared to the dot com bubble of 2000. However, the key takeaway is that diversifying away from the higher flyers dragged performance down in 2021.

While earnings growth was better than we expected in 2021, rising prices reflected that. As you know, we look at a variety of measures of valuation. As you can see below, only one measure suggests that stocks might be a bargain and we would challenge that assertion because it relies on interest rates that have, in our judgment, been manipulated by the Fed.

S&P 500 valuation measures

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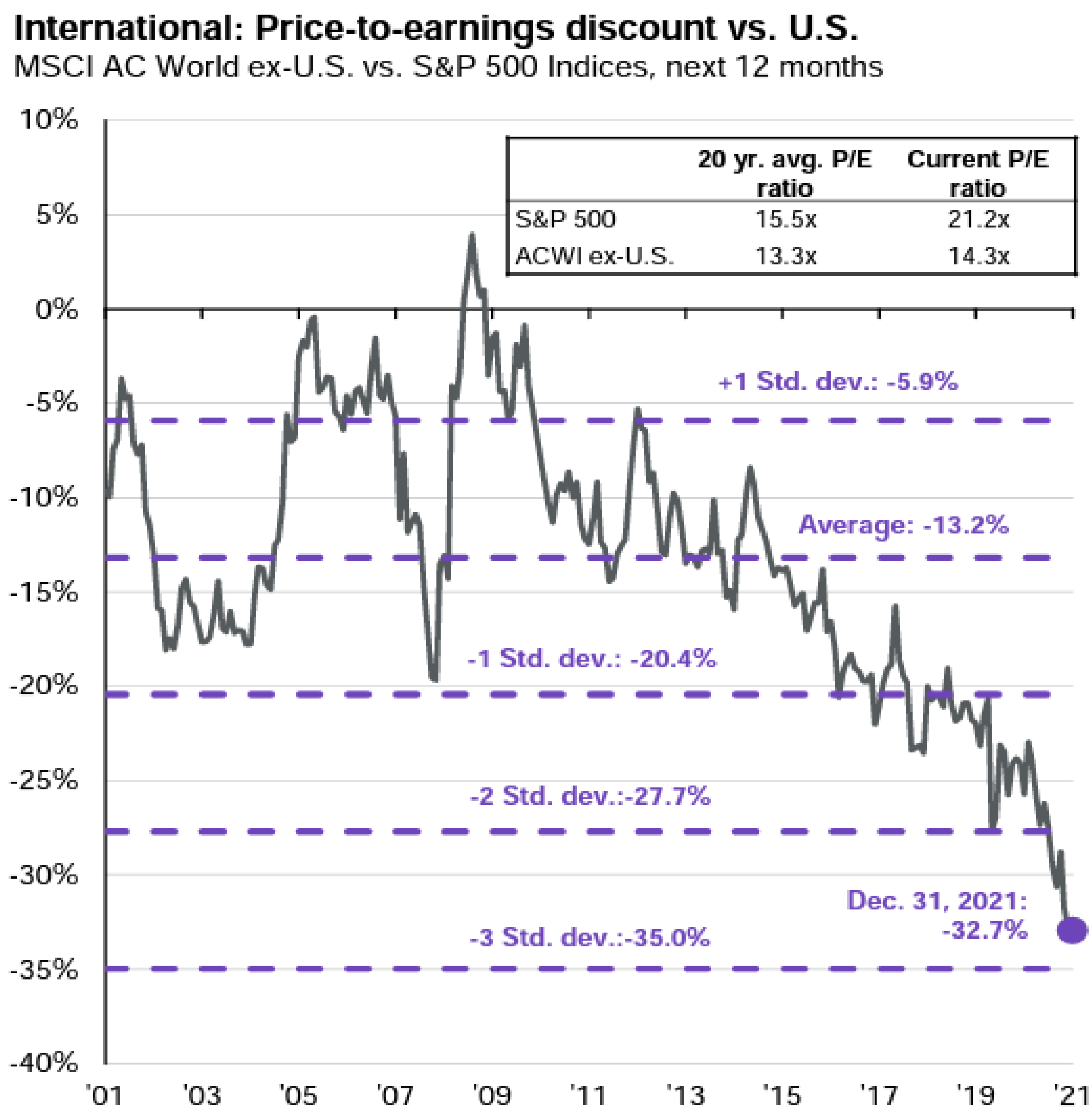
On the international front, we would observe that one of the now time- honored traditions at the end of the calendar year is to note that international stocks are inexpensive compared to US equities. As new capital is allocated in the New Year, we often see green shoots of outperformance for foreign equities. However, it seems like all that hope is dashed by the time we reach Valentine's Day. 2021 was no different as the chart below highlights. At some point the extreme disparities will correct, but it has been a tough decade to have exposure to foreign stocks.



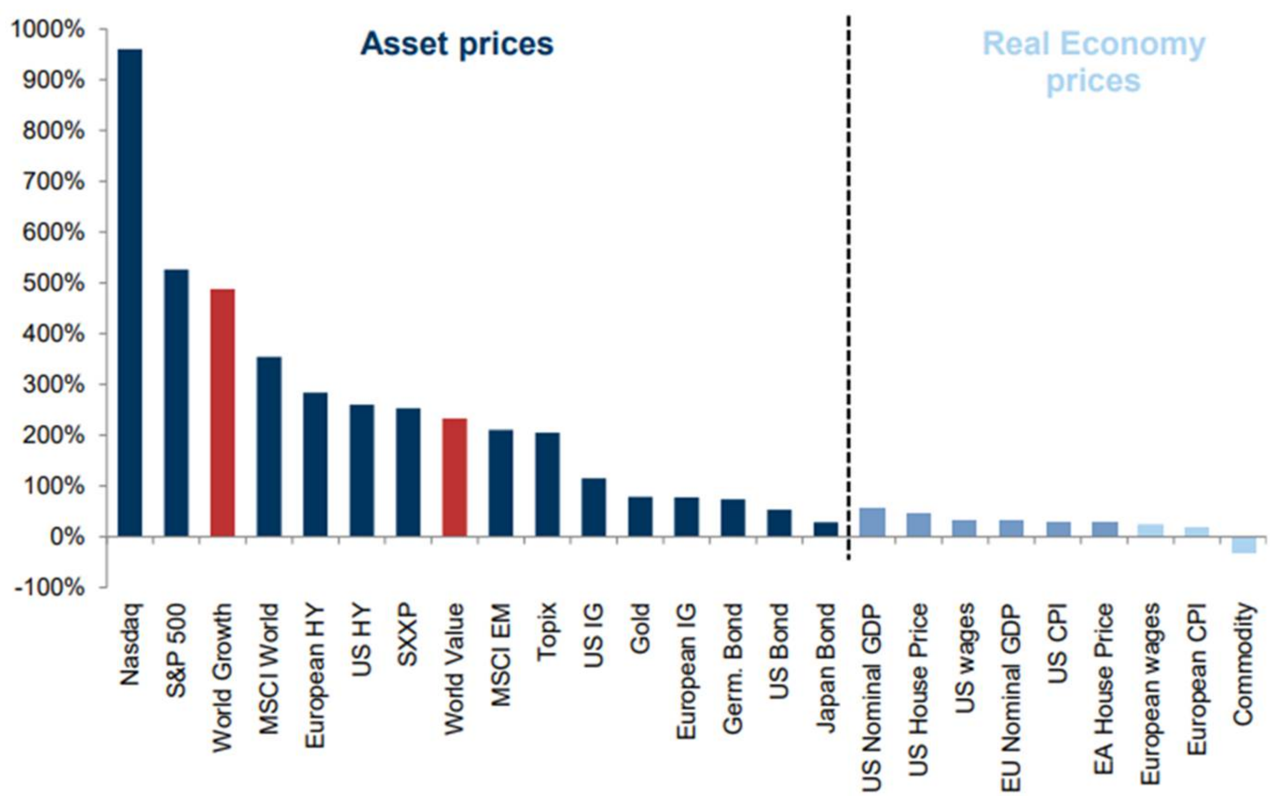
Key Considerations for 2022

Valuations are critical to understanding risk and return, but they do little to inform shorter term market movements. We continue to suggest that the action of policy makers has been central to the movement of both stock and bond markets since 2008 and we would be surprised if that relationship changed in 2022. The question really involves what policy makers will do as opposed to what they promise.

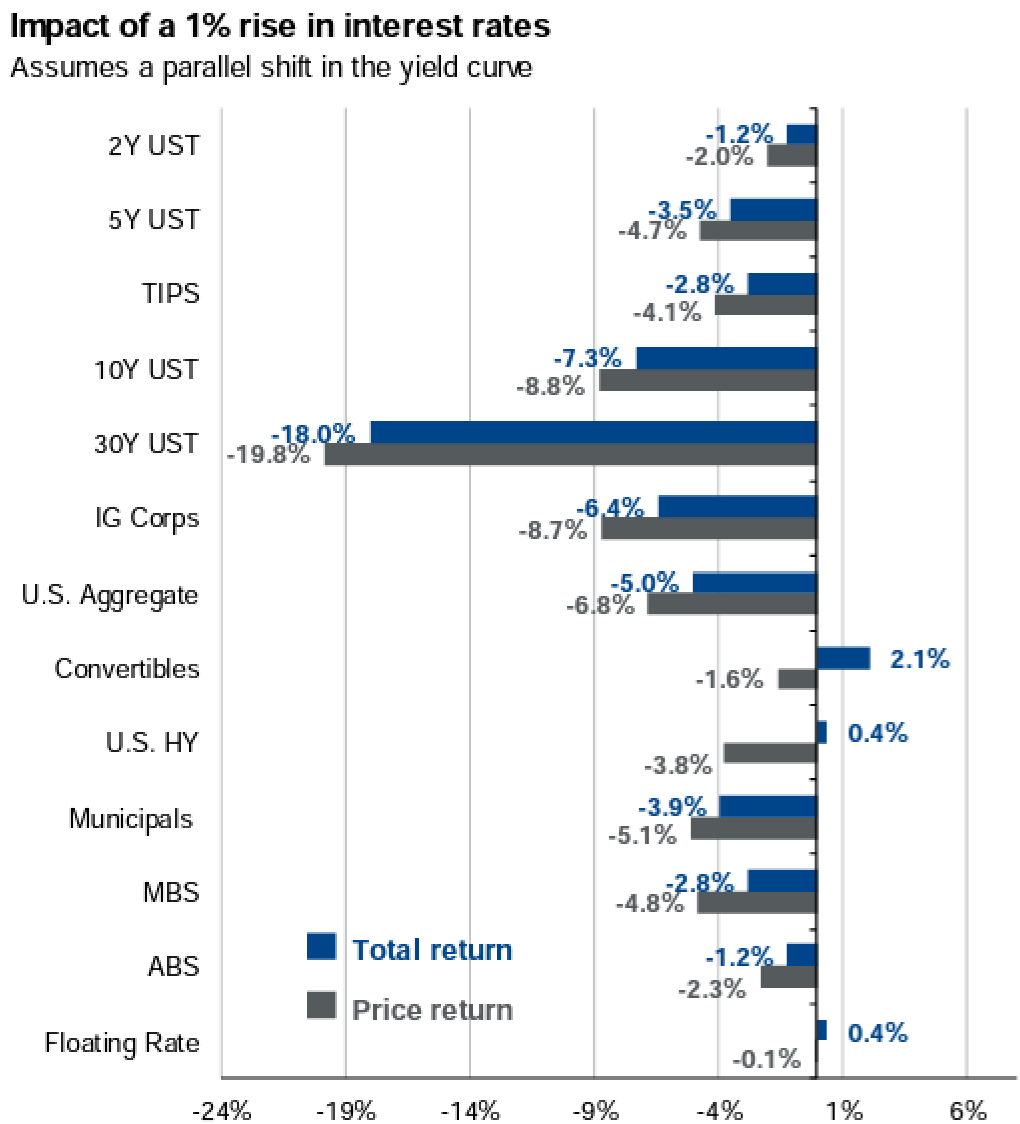
A case can be made that since the Covid crisis began, fiscal policy (i.e., government spending and tax policy) has been more impactful than monetary policy (i.e., what the Fed and other central banks do with interest rates and the money supply). The volume of Federal spending, and resulting deficit, has been mind boggling since the March 2020 lockdowns. We agree that in the early stages of the crisis, government support was important in alleviating the worst of the pandemic's economic impact. The question that reasonable people might debate is how much was enough. Regardless of where you stand on that question, we are now seeing the impact of that deficit spending in the form of sharply higher inflation (which even the Fed notes is no longer "transitory") and a labor market in chaos.

Not wanting to waste a good crisis, the Biden Administration has been pushing its Build Back Better legislative package. As of this writing, a closely divided Senate doesn't appear ready to move ahead on this front. We applaud this reticence as we don't think pouring gasoline (in the form of $5 trillion of additional deficit spending over a decade) on a bonfire (6.8% year over year CPI increase, the fastest rate of inflation since 1982) is a good idea.

The inflation pressures are morphing from an economic issue to a political issue and we believe that will keep the heat on the Fed to follow through on their promise to taper bond purchases (which began in November with the plan to stop buying by March), then begin the exercise of shrinking their balance sheet and/or raising rates. Timing and details are to be determined, but the directional impact will be less liquidity in the system coupled with less incremental fiscal stimulus. This means that the economy, and the financial markets, may have to make due without extraordinary support. Given the powerful moves in financial assets since 2009 (highlighted in the chart below), it probably isn't realistic to expect 2021 results to be carried into 2022 and we don't have the hope.



For investors who are skittish about investing in richly priced equities, bonds offer cold comfort. There is no doubt that global central banks are "behind the curve" in adjusting rates to reflect current inflation realities. As noted below, even modest moves higher in rates (i.e., the consensus for 2022) implies a difficult world for bond investors.



What Makes Us Nervous

The short answer is everything. Asset markets priced for perfection don't seem consistent with an economy laboring with inflation pressures, supply chain disruptions, labor shortages, the ongoing struggle with Covid and a dearth of political leadership.

Any or all of those issues could take centerstage in 2022. More specifically, while we hope that Omicron is helping us toward herd immunity, the fact is that we could have a more difficult variant to contend with at any time. Geopolitics are always a flash point, and a more assertive Russia and China could trigger a colder war or even a hot war. Relations with Iran don't seem to be improving. Economically, Turkey is in the middle of a slow- motion economic suicide while China is struggling with the economic impact of its debt bubble and its zero covid policy. Emerging markets chaos may not cause a global recession but it could be a canary in the coal mine for trouble ahead. This is but a modest list, and we are sure that you could add your own concerns.

Our greatest fear, however, is a Fed misstep. The Fed, with the largest accumulation of economics PhDs in the world on staff, has a dreadful record of forecasting. A skeptic could look at last year's insistence that inflation was transitory and you wouldn't be wrong to conclude that they also aren't very good at noticing what is happening in real time. This record of futility, however, doesn't seem to create much humility. Instead, they confidently charge ahead and manipulate the markets and the most important price in the world which is the price of money in the form of interest rates.

One of our favorite market observers, Jim Bianco, has commented that when the Fed begins the exercise of changing policy and raising rates (always too late), they continue until they break something. Sometimes they break the economy and trigger a recession. Other times, they break a corner of the market like they did in the fall of 2019 with repo financing. Whatever they break, the result is a predictable retreat back to easier policy. Perhaps that is the reason that even with high inflation and rising short term rates, longer rates including the rates on ten and thirty- year bonds haven't moved up much. Perhaps investors are concerned that the economy is fragile and they are confident that rates will go down once the Fed makes its policy error. If the past is prologue, this may create some short- term discomfort, but would likely set the stage for one more equity market blowoff fueled by easy money.

How does this impact portfolio positioning?

If easy money is going away, or at least going on vacation, we think investors will be rewarded by favoring high quality investments, remaining diversified and being "close" to their cash flows. When we say be close to your cash flows, we would contrast a high- quality consumer staples company sporting a well- covered and growing dividend with a speculative electric vehicle company (think Rivian) that has yet to build or deliver on the promise of their earth saving autos and trucks. When capital is cheap, a flyer on the latter can make sense. When capital is more expensive, we hope and believe that fundamentals will be the key driver of assets returns. That belief will continue to inform our recommendations to you.

We are grateful for your trust and confidence. As we begin a New Year, please know that we will continue to work hard to deliver to you the quality, integrated and unbiased financial advice and counsel that you expect from us. As always, we look forward to your thoughts, comments and questions.

A note on Taxes

It is hard to believe that it is time to begin discussing taxes but the 2021 tax return filing season is upon us. The old adage that the early bird gets the worm may be valuable advice, but in tax filing, the early bird often gets to amend their return.

Schwab will be sending out tax reporting data beginning this month. While they work hard for accuracy, they are often required to issue the dreaded "corrected" 1099 as they receive updated information from fund managements. Our suggestion is to wait to deliver your tax information to your preparer until at least the first of March. This can't guarantee that you won't receive subsequent corrected 1099s, but it minimizes the chance.

We look forward to assisting you in gathering the data to make the tax filing process as smooth as it can be.