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Investment and Financial Consultants

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2021 ECONOMIC AND FINANCIAL MARKETS REVIEW

Despite concerns regarding inflation and COVID-19 variants, the stock market performed very well in 2021. Stock market investors looked past rising inflation and COVID-19 fears and focused more on the Federal Reserve Board's highly accommodative monetary policy and solid corporate earnings. Investors also appreciated fiscal stimulus provided by Congress, as significant infrastructure spending is expected to help spur continued economic growth. As a result, the S&P 500 Index ended 2021 up 26.89%, while the Dow Jones Industrial Average ended the year up 18.73%. Bonds did not perform well overall in 2021, as the Bloomberg Barclays U.S. Intermediate Government/Credit Bond Index declined by 1.44% last year.

When the pandemic started, the Federal Reserve Board lowered interest rates to near-zero and began printing $120 billion per month to purchase government-backed bonds. This policy was intended to prevent another financial crisis, stimulate the economy, and help support the job market. However, the Fed has continued this powerful monetary stimulus despite a solid financial system, a rapidly growing economy, and a very robust labor market. In fact, the labor market is so strong that many employers are having difficulty finding workers to fill open positions. The Fed did announce late last year that they would begin to reduce the amount of money they are printing each month. However, they will likely not begin raising interest rates until they are finished printing money sometime later this year. This means that interest rates are probably going to remain very low for quite some time.

Stocks typically appreciate when the Fed's policy is accommodative because ultra-low interest rates make other investments like Treasuries, money market funds, and CDs less appealing. However, one problem with printing money and keeping rates near zero is that this policy can perpetuate inflation. Inflation is already a concern as supply chain disruptions have led to product shortages while demand for goods has increased. Rising demand without adequate supply has resulted in the highest inflation in decades. The labor shortage has also led to wage inflation. Although moderate inflation is not necessarily a bad thing, high inflation erodes consumer purchasing power and could cause a recession.

Ironically, the best policy to fight rising inflation is for the Fed to raise interest rates and reduce the amount of money in circulation. However, the Fed is still keeping interest rates extremely low because they are more concerned about supporting economic growth and helping to create jobs than fighting inflation. If inflation worsens this year, the Fed may be forced to raise interest rates sooner and faster than investors currently expect. This could lead to an adverse reaction in the financial markets as rising interest rates erode future corporate earnings expectations and bonds generally decline when interest rates rise.

In addition to the Fed's extremely accommodative monetary policy, Congress continues to launch expansive fiscal stimulus. The federal government has spent trillions of dollars on programs designed to help individuals and businesses weather the storm of the COVID pandemic. Additional fiscal stimulus resulting from the recently passed infrastructure bill should provide even further stimulus to the economy. Although it has helped the economy and stock prices, this government spending has caused the U.S. to take on more debt, which could become an issue for financial markets if not held in check in the future.

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A key for the stock market in 2022 will be whether corporations can continue to grow their earnings at the same pace as they did last year. If so, rising corporate profits could offset concerns regarding inflation, the national debt, and COVID-19 variants. However, if corporate earnings do not continue to exceed expectations due to rising costs or slowing revenue growth, the stock market will likely decline.

After several years of positive momentum, it would not be surprising to see a stock market decline at some point this year. Investors have become very complacent, and in some cases, overexuberant. Historically, when investors are too optimistic and greed sets in, the stock market performs worse than when investors are cautious, leading the stock market to “climb a wall of worry.”

We continue to recommend short-term bonds rather than longer-term bonds because short-term bonds are less sensitive to rising inflation and interest rates. We also prefer large company stocks over small company stocks. After several years of U.S. stocks outperforming, foreign stocks appear to be relatively inexpensive. Finally, gold prices should benefit this year if inflation persists or the economy begins to struggle due to COVID variants.

As always, we will continue to monitor ongoing economic and financial market conditions. In the meantime, please contact us if you have any questions regarding your investment portfolio or the financial markets in general.

* *Index returns were obtained from the Wall St. Journal and Bloomberg Barclays on January 1, 2022.*

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