PDS Wealth Management

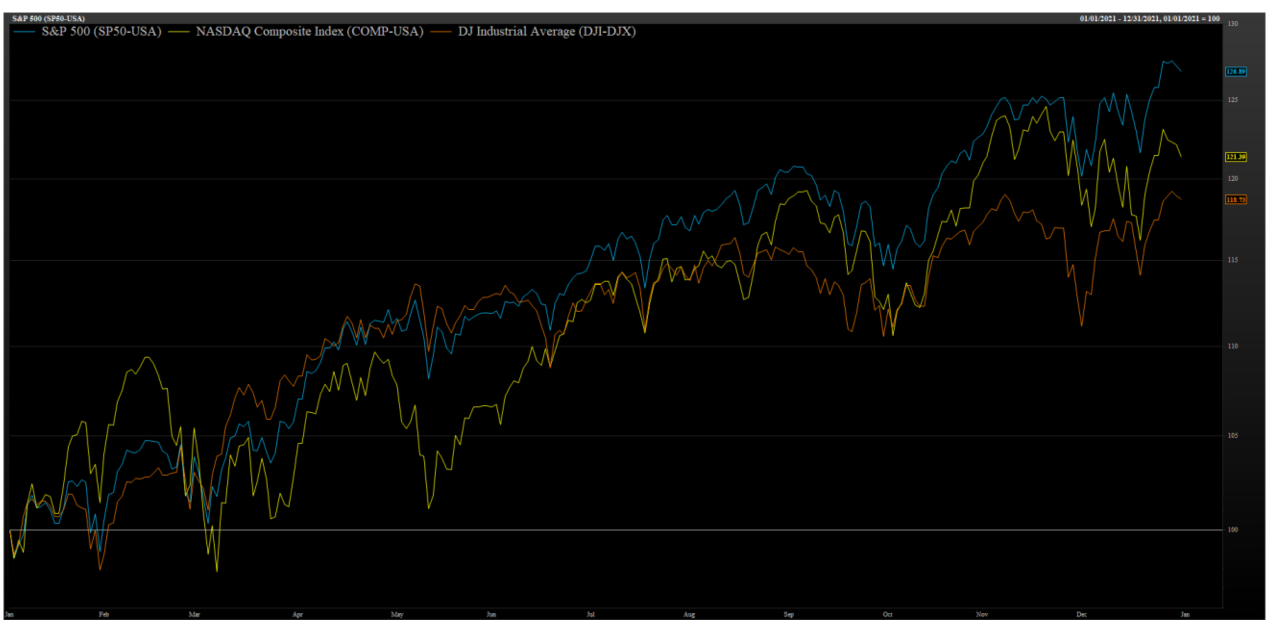
Quarterly Investment Report – Q4 2021

Welcome to the third edition of the PDS Wealth Management Investment Report wherein we will recap market and economic events of 2021 and offer some thoughts on the year ahead. 2021 proved to be an outstanding year for the stock market, though bond investors saw modest declines. As is our usual stance, we refrain from making market predictions for 2022, but we'll venture that the year will not be boring. On behalf of the team at PDS Wealth, we wish you and your family all the best for a healthy and prosperous 2022!

Market Review

Stocks

The S&P 500 gained 27% in 2021, the third year in a row of solid gains. The index was up 11% in the fourth quarter. The largest drawdown of the year was only ~5%, much better than the average 14% pullback experienced since 1982. Worth noting that in mid-term election years like this one, according to Dan Clifton at Strategas Research, stock market corrections have historically been more severe at ~19%. The good news, however, is that these pullbacks have been good buying opportunities, "with stocks up one year from the low every time since 1962, and by an average of 31.6%," says Clifton.



Source: FactSet

We are only a few days into the new year, but the S&P 500 is down 3% with value stocks outpacing growth stocks out of the gates with an 8.5% lead.

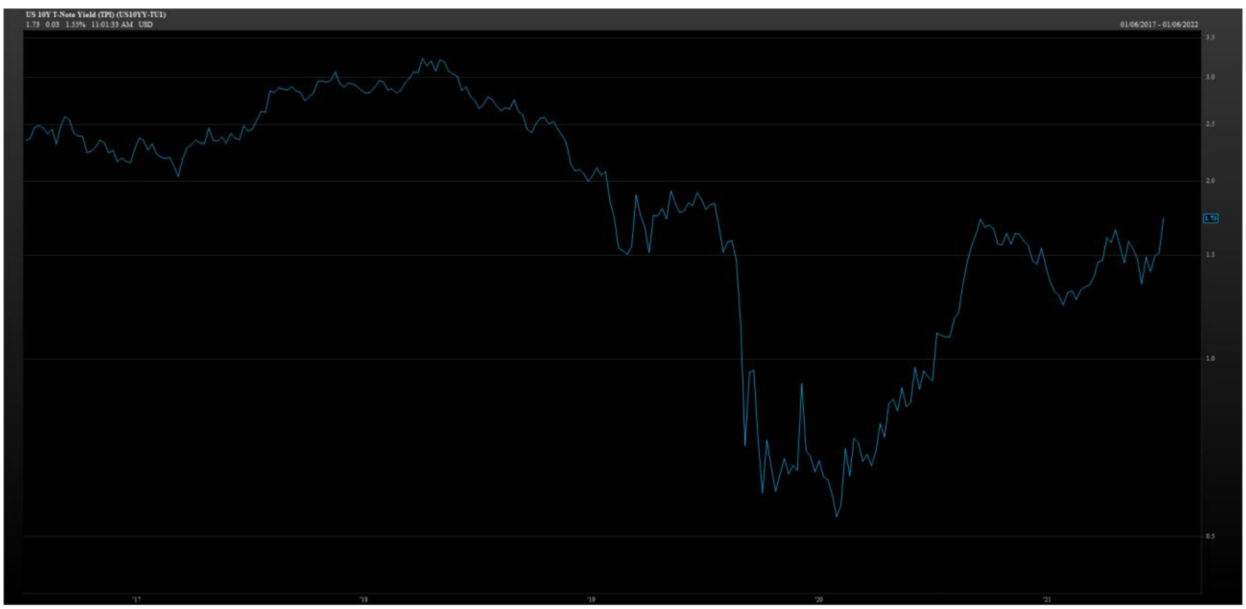
Much has been made about the top-heavy nature of the cap-weighted indices (like the S&P 500) where a small number of companies (namely, Apple, Microsoft, Google, Facebook, and Amazon) compose an outsized portion of the index. However, there has been broad participation by the "average" stock, as evidenced by the near identical performance of the "cap-weighted" S&P 500 Index in 2021 and the "equal weighted" S&P 500 Index.

Every sector posted a positive return in 2021. Energy was the best performer with a 55% gain, followed by real estate (+43%), Financials and Technology (both +35%), Materials (+27%), and Healthcare (+26%). Consumer Staples and Utilities were the relative laggards with a gain of ~18%.

The small-cap Russell 2000 Index ended the year with a +14.8% gain while international markets, as measured by the FTSE All-World ex-US Index, rose 14.1% .

Bonds

The yield on the 10-year treasury note started 2021 at 0.93%, reached a year-to-date high of 1.78% on March 30th, and closed out the year at 1.51%. Though only a few days into the new year, yields have come out of the gates higher as the Fed's faster taper kicks in and higher rates expectations are priced in. As the below five-year chart shows, the yield on the 10-year Treasury is approaching post-COVID highs:



Source: FactSet

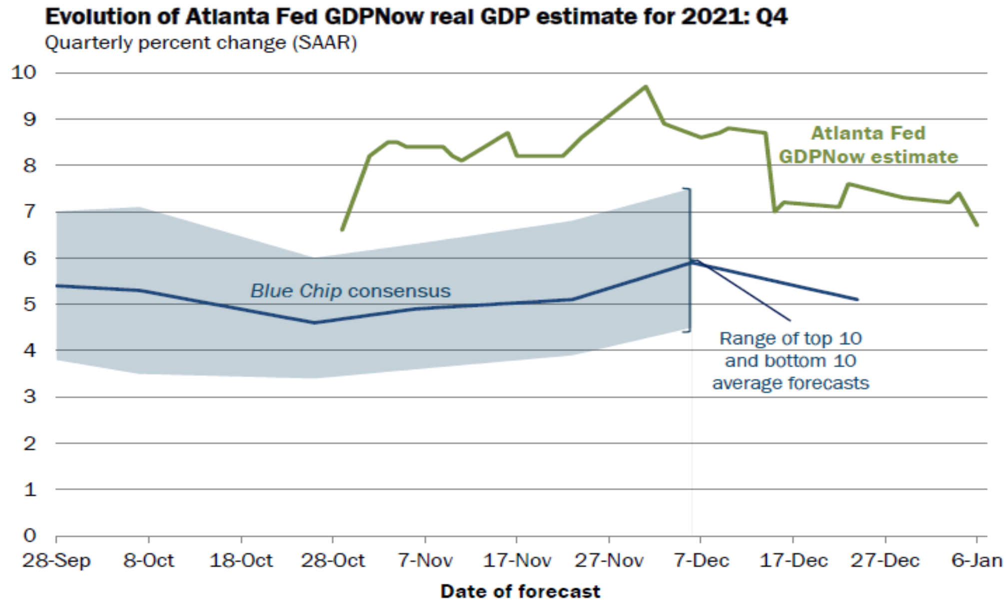
The Bloomberg Barclays US Aggregate Bond Index fell 1.54% for the full year 2022, only its 4th annual drop since the index's 1976 inception. The index yields 1.6% with a 6.6 year duration.

The S&P 500 Investment Grade Corporate Bond Index fell 1.04% in 2022 and currently yields 2.3% with a duration of 8.4 years. The S&P 500 High Yield Corporate Bond Index returned 4.07% in 2022 and currently yields 3.5%.

Economic Review

The US economy continued to grow in the back half of 2021, albeit sporadically as supply chain bottlenecks and COVID flareups hindered activity. The GDP reading for Q3 came in at 2.3% while Q4 estimates are running at a more robust 5.7%, though the below chart showing the Atlanta Fed's Q4 GDP estimate indicates a potential upside surprise.

Source: Federal Reserve Bank of Atlanta *Source: Federal Reserve Bank of Atlanta*

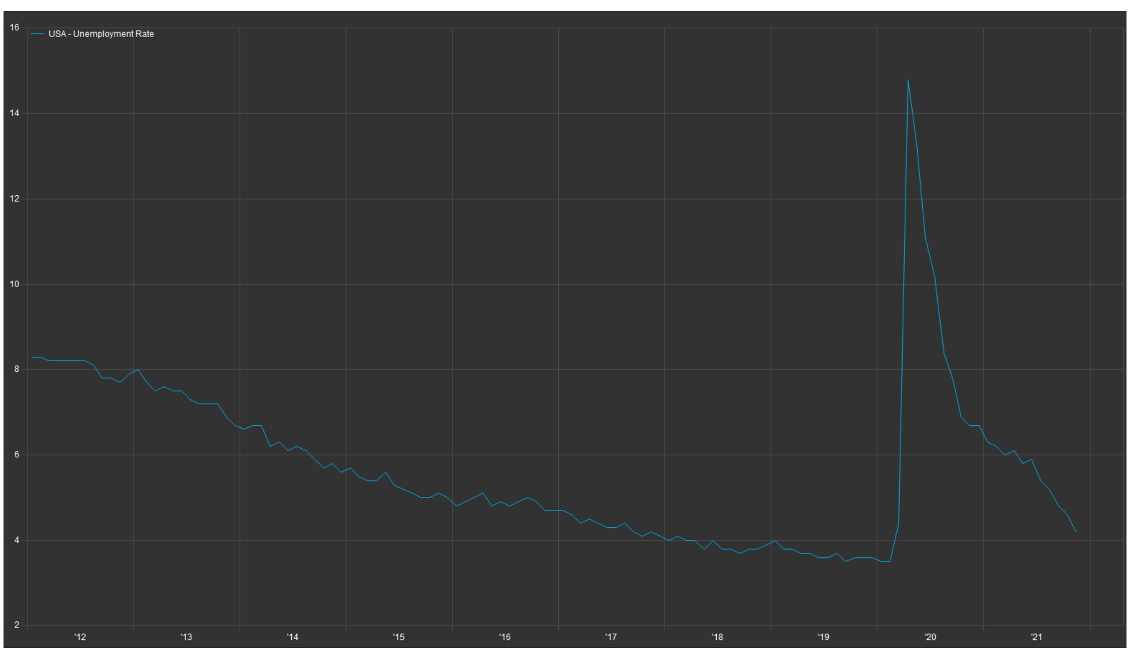


Source: Federal Reserve Bank of Atlanta

The Federal Reserve has noticeably changed their tune since our last report. In early November with the labor markets strong and inflation stubbornly high, the Fed announced the beginning of its "tapering" of asset purchases, which were to be reduced by $15bn per month and ended by June. In mid-December, the Fed decided to double its reduction of monthly purchases to $30bn per month, which would wind down the program by March.

Employment

As visible in the below 10-year chart, the US unemployment rate has nearly retraced the entire COVID induced rise with the latest reading from December of 3.9% vs 3.5% in early 2020. Job openings remain plentiful as well, with over 10 million job openings counted in the latest JOLTS report.

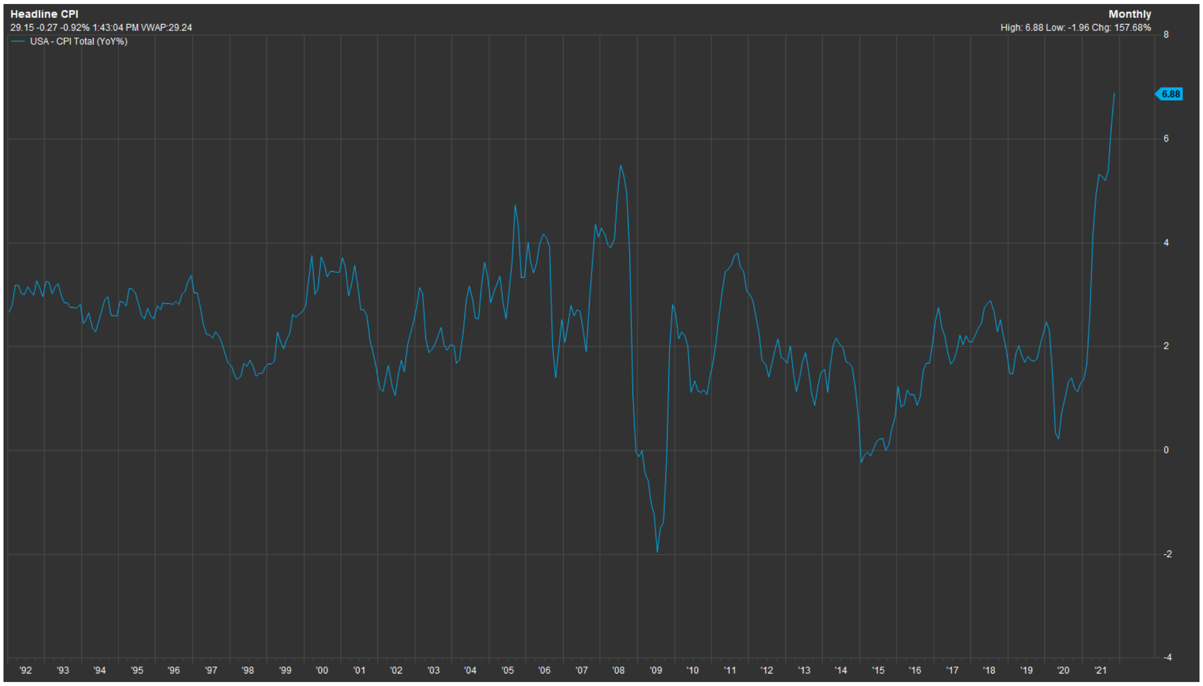


Source: FactSet

The Fed has indicated a desire to maintain interest rates at zero until "full employment" is reached, which appears to be at hand. Markets are expecting the first rate hike in March, and increasing chances of further hikes in June, September, and December.

Inflation

In our last report we highlighted the incredible growth of the money supply driven by the Federal Reserve's aggressive asset buying programs. At the time, the Fed still considered inflation to be "transitory." Since then, the Fed has admitted that the term no longer applies. Perhaps "persistent" would be a better description, or if you prefer a jingle, Buster Poindexters hit song from 1987, "*Hot Hot Hot*" comes to mind. How you feelin'? If you've bought anything in the last few months - groceries, gas, toys, electronics, a car, a house – you've likely noticed higher prices across the board. The most recent consumer price index (CPI) readings are the highest since the early 1980s (see below chart). October's headline CPI came in at +6.2% y/y and November's reading was even higher at +6.8%. Stay tuned for December's report on January 12th.



Source: Factset

Outlook

As we move into 2022, there are plenty of issues that have our attention, some new, some old. Here are a few of them:

Geopolitics/Global Issues

- Do already tense US relations with China and Russia flare up or calm down? Does China make a move on Taiwan, Russian on Ukraine?
- Does COVID become endemic or do new variants continue to emerge? How do strict lockdown measures in countries like Australia and China impact global growth and supply chains?
- When, where, and who will the next cyberattack target?

Economic

- Has the Fed missed their opportunity to rein in inflation? Will they be forced to tighten monetary policy more aggressively, and if so, does that tip the economy into recession?
- How fast will the Fed reduce their sizable ($8.7 trillion) balance sheet; how many times will they raise interest rates in 2022?

Corporate Fundamentals

- Q4 earnings are forthcoming, are expectations missed/met/exceeded? Is company guidance above/below/in-line with forecasts?
- How much are margins squeezed by higher input costs vs. ability/inability to pass through price increases?

- Can companies hire the workers they need? Do wages continue to keep pace with inflation?

Domestic Political

- US midterm elections will be held on November 8; do Republicans take back either house?
- Are Biden and the Democrats able to pass further stimulus, raise taxes, or any part of the Build Back Better agenda?

All the best for 2022!

Paul Spencer, CFA®

Director