TOPS–THE OPTIMIZED PORTFOLIO SYSTEM®

A Message from the TOPS® Portfolio Management Team

4th Quarter 2021 Market Commentary

"Positive Momentum into Year End, with Questions Left to be Answered in 2022"

In the 4th quarter, markets rebounded from September weakness to finish the year with strong positive momentum. Looking back, roughly 1/3 of the total 2021 returns were achieved in the last three months of the year. Major events this quarter were the emergence of the Omicron variant, more clarity from the Federal Reserve on a plan to reduce stimulus, the passage of the Infrastructure and Jobs Act, shelving of the Build Back Better plan, and continued high inflation.

After discussing Q4 and full year 2021 financial market results, we will address three topics important to TOPS portfolio returns and strategies:

1) Inflation: What will happen to inflation and what are the repercussions?
2) The Fed: Will the Fed fight inflation aggressively or not?
3) Return Expectations: Is it the time to search for a new leader beyond large cap growth?

Fourth Quarter and Year-To-Date Markets Review

For Q4, most stock indexes had positive returns. This includes, but is not limited to, S&P 500 Growth up +13.4%, S&P 500 up +11.0%, MSCI World Real Estate up +10.7%, and S&P GSSI Natural Resources up +8.1%. The S&P MidCap and S&P Small Cap both posted positive returns of +8.0% and +5.6%, respectively. MSCI Emerging Markets ended the year with a negative quarter, down -1.3%.

A positive fourth quarter helped stock market indexes lock in above average returns for the year. The best performer for the year was S&P GSSI Natural Resources, up nearly +40.0%. The S&P 500 recorded a strong +28.7%, while S&P Small Cap and MidCap put up +26.8% and +24.8%, respectively. Strong results were also achieved by MSCI World Real Estate, up +28.7%. The laggards on the year remain MSCI EAFE (developed international) returning +11.3% and MSCI Emerging Markets down -2.5%.

Bond yields were flat in the fourth quarter as the 10-year US Treasury yield stayed at 1.52%. Total returns for the Barclays US Aggregate bond index were also flat on the quarter and the Barclays US TIPS returned +2.4%. High Yield corporate bonds had positive returns, while Investment Grade Corporates and Emerging Markets bonds saw negative returns.

The 10-year US Treasury Bond yield rose from 0.93% to 1.52% over the year. Barclay's US TIPS recorded a solidly positive return of +6.0% for the year versus the broader Barclay's US Aggregate at -1.5%. US High Yield achieved positive returns while developed international and emerging markets were negative.

Inflation: What will happen to inflation, and what are the repercussions?

Prices in the US are clearly higher leading into 2022, as shown by multiple measurements of inflation. With the economy running stronger than it has in a long time, the money supply about $5 Trillion higher than the beginning of 2020, supply chains strained, skilled labor hard to find, and measurements coming off tepid bases registered during the recession; it is no surprise inflation is finally arriving.

For economists and money managers this is a big change, as inflation has remained subdued for well over a decade. As we have discussed in this commentary over the years, several long-term macro deflationary factors have been keeping inflation down. Factors such as aging population, lower economic growth rates, technological innovation and international trade have been suppressing any hints of inflation for some time. However, the lid has blown off and these longer-term trends have failed to subdue recent pressures, as the US Bureau of Labor Statistics recorded the largest inflation jump in over 40 years for the Consumer Price Index (CPI) in December at a 6.8% year-over-year increase. Rising prices in energy and food were a major driver; however, even when stripping out those components the ‘core' reading of inflation rose 4.9%.

From our standpoint, inflation is the leading concern for markets heading into 2022. Each day, we are researching and debating whether inflation is transitory or here to stay and discussing the impact on our portfolios. A particular area of focus is wages, as increases in wages can help to transition short term spikes in inflation (transitory) to longer term secular inflationary trends. To this point, increases in wages have not been a leading driver of inflation, but that may be changing. Per the November Employment Situation Report from the Bureau of Labor Statistics, the average hourly earnings for all private sector employees rose 4.9% over the last year.

Helping to drive wages higher is a scarcity of labor. While many unemployed from the recession have found jobs, many others are leaving the labor force entirely. According to M&N, 58.8% of the US population is employed currently versus 61.1% pre-pandemic. The 2.3% percentage difference equates to roughly 7.5 million fewer people working or actively seeking employment today. Some have called this, “The Great Resignation.”

While we are happy for the baby boomers finally getting their opportunity to enjoy retirement, the birthrates in the US have fallen below replacement levels. This shrinking labor force could continue to place pressure on wages, which is holding our attention and stopping us from dismissing inflationary figures as purely temporary.

Historically, stocks have been a relatively good place to be invested in periods of moderate inflation. Inflation can be in tandem with solid economic growth, which drives earnings and fuels stocks. Likewise, stocks are one of the few investments with the opportunity to provide returns high enough for investors to avoid losing purchasing power in periods of inflation. Therefore, investors in stocks should be in the right place should we enjoy a period of moderate inflation.

The primary concerns regarding inflation are the impact on bond investments and the measures which may be employed to keep inflation in check. Our Portfolio Management Team is spending significant time and effort in monitoring inflation and modeling the impact inflation could have. We feel the portfolios are well designed to balance this risk, along with the many other risks and opportunities in global financial markets.

The Fed: Will the Fed fight inflation aggressively or not?

There are some similarities between economists and pharmacists, as both try to provide a medicine to cure any ailment. In economics, the common prescription to fight inflation above target levels is to raise interest rates. By raising interest rates, the Federal Reserve should be able to tap the brakes on inflation. Like any commercial on TV outlining the side effects of pharmaceuticals, there are side effects to raising interest rates as well. Likewise, it is very important interest rate increases are enacted in the right dosage.

Federal Reserve Chairman Jerome Powell has outlined many times over the past year the Fed is confident they can control inflation. Chairman Powell has outlined primarily the Fed will be nimble, able to appropriately gauge the pulse on inflation and the appropriate dosage of rate rises. However, he has stopped short of outlining whether the Fed will be aggressive or not in the short term. This “trust me” policy has left markets guessing and professional money managers like us forced to allow for multiple scenarios.

Some market pundits feel the Fed is already behind the curve and they will have to aggressively raise rates in 2022 to cool inflation. Others are confident the Fed will expertly execute their Goldilocks strategy. Currently, markets overall are expecting to see three different 0.25% rate increases in the Federal Funds Rate in 2022. The pace and level of these increases is likely to have a major impact on 2022 results in stock and bond markets.

Lastly, there is much debate on how longer-term bonds will react to increases in short term rates. As the Federal Reserve increases the Fed Funds Rate, there is no assurance interest rates on 10-year US Treasury bonds will react. As such, we could experience what is referred to as a yield curve flattening, when interest rates at different maturities transition towards parity.

Our Portfolio Management Team is watching the Fed and interest rates closely. We have implemented several different strategies in our bond allocations to balance the risk and return opportunities of the multiple different scenarios we outline.

Return Expectations: Is it the time to search for a new leader beyond large cap growth?

Large cap growth US stocks were the clear performance leader among major global asset classes in 2021, as they have been over the past 5 years. For the past 5 years, large growth stocks have returned about 24% annualized, which has led large value (12%), mid cap (13%), small cap (12%) and international developed (10%).

Looking forward to 2022, the path to outperformance for large cap growth stocks appears to be different. The spectacular run-up in growth and tech stocks over the last decade has been a combination of earnings growth and investors bidding up multiples to historically high levels. A valuation multiple we often reference is the Price/Earnings ratio (P/E). Historically, the P/E ratio of the S&P 500 has been around 17. To produce the exceptional returns, the Trailing P/E ratio of the S&P 500 has risen to around 25, with the Forward P/E in the 21/22 range.

According to Dr. Ed Yardeni, the forward P/E of the S&P 500 has remained remarkably high, mostly because the valuation multiple of the S&P 500 Growth stock price index has been amazingly steady, at around 28.0 since mid-2020. Amid a rise in the inflation rate and the increasingly hawkish stance of the Fed, these stable valuations are uncommon. Potentially, the steadiness can be attributed to liquidity provided by monetary and fiscal policies since the start of the pandemic.

Growth stocks, specifically tech stocks, tend to benefit from lower interest rates. Not only do low rates aid borrowing, but they also make growth stocks more attractive to investors compared to more conservative investments. As an example, if an investor could earn 5% on the 10-year US Treasury, this would reduce the attractiveness to the risk inherent in growth stocks. Therefore, if we do see rates rise, it could put pressure particularly on valuations of large cap growth stocks.

So, will we have a new leader among asset classes in 2022 and over the next few years? As our investors should know, at least those who have read our writings over the last 20 years, it is incredibly difficult to predict short term market results. However, over the long term, we do feel there is opportunity for asset classes beyond large cap growth to make up some of the return gap accumulated over the last decade.

In their recently released 10-year return expectations, Vanguard revealed their return expectations for US large growth stocks trail those of US value stocks, international stocks, and several other major asset classes. Value stocks tend to trade at lower valuations and can often be boring companies, like healthcare and financial stocks.

Large cap US stocks are the largest equity concentration in our portfolios currently. We continue to be believers in the long-term return potential of the US stock market. However, as we have seen in periods like the first decade of the millennium, a benefit of diversifying risk into a wide range of global asset classes is the opportunity to experience desirable returns in periods when large cap US stocks do not lead. We have balanced the risk and opportunity to be able to benefit if the large cap US stock rally continues, however, TOPS stands to provide appropriate relative results if the baton is handed off to other diversifying asset classes which currently provide more attractive valuations.

TOPS Portfolio Strategies

All signs lead us to believe 2022 will be quite different from 2021. While the opportunity exists for portfolios to provide marked additional gains, we feel the path to success will likely look different than the story we just experienced. There are quite a few economic pressures, like inflation, which may force the hand of the Federal Reserve to act.

The TOPS portfolio team will continue to monitor the constant flow of economic and financial market data as we strategically implement our philosophy of maintaining broadly diversified portfolios. We feel our risk managed approach is well suited to serve our investors and provide appropriate returns over time.

TOPS® Portfolio Management Team

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