Daniel Wildermuth's
MARKETCOMMENTARY

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Market Ends Strong, but Faces Significant Challenges

The market ended the year with nearly all indexes at or near all-time highs. The S&P 500 was up nearly 29% in 2021 and over 26% per year over the past three years having more than doubled from the beginning of 2019 through the end of 2021. During the two years of COVID, the market is up an amazing 52%, turning in performance few would have thought possible in January 2020. Over the past decade, the index is up more than 16% a year. All these measures are far above the long-term average annual returns of 9% to 10% which is already sitting at an elevated level because of the last decade's performance.

Looking forward in 2022, the market faces several significant challenges that will likely lead to a different outcome. Valuations remain over a standard deviation above levels over the last 15 and 25-year periods. In addition, the stock market's rise narrowed to a short list of big tech companies. Five of the S&P 500's biggest stocks accounted for more than half of the broad benchmark's gain since April according to analysts at Goldman Sachs. There have been only 11 other instances since 1980 where market breadth narrowed as sharply as it did between April and October, according to Goldman analysts. Following most of those periods, the analysts

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said, the S&P 500 posted below-average returns over subsequent one-, three-, six- and 12-month intervals.

Expectations that stock prices will fall over the next six months jumped to 42% earlier this month, the most bearish reading in more than a year, according to a weekly sentiment survey conducted by the American Association of Individual Investors. FactSet on Friday said the number of companies issuing negative earnings guidance for the fourth quarter outpaced upward revisions for the first time since the second quarter of last year. Corporate earnings are also likely to worsen as more companies grapple with inflation and supply-chain blockages.

Inflation remains a significant challenge hitting 9.6% in November (actually north of 10% during last few months). Inflation has historically been neutral for earnings, but negative for multiples (valuation). Higher inflation prompted the Fed to announce plans to raise rates three times in 2022. Clear signs exist of a wage price spiral starting, and pundits are speaking of another Saturday night massacre.

Morgan Stanley, one of the most vocal and accurate Wall Street forecasters of a V-shaped market recovery after the pandemic hit last year, predicted that the S&P500 will finish 2022 6% below current levels citing various issues such as valuations, a post-COVID hangover, slowing growth, and shifting government policy. Still, other firms remain optimistic. Goldman Sachs projects 9% gains next year, UBS 6% and JPMorgan 6% through the middle of next year.

Several banks noted that anticipating the actual change in financial conditions from an accommodative to a tightening Fed policy is challenging and usually yields disappointing results.

Realistic expectations for future market returns are likely more important than ever. The market will

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face a future slowdown, but timing the change will be challenging as always.

In summation, we expect 2022 to be a challenging year for financial markets. High valuations, high inflation, geopolitical risk, COVID-variant risk, and the transitioning of global central bank policies make for a difficult backdrop with plenty uncertainty. As active managers, we seek to identify opportunities that present attractive return/risk profiles. We are not trying to meet or beat passive benchmarks at all costs; we are comfortable leaving some return potential on the table when we see negative asymmetry in return/risk. We approach 2022 with healthy caution and remain steadfast in our valuation discipline and risk management.

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