WESTEND Advisors

Economic and Market Commentary

December 15, 2021

2021 Year-in-Review
A Study in Resilience

While successive waves of COVID-19 and various economic and political disruptions presented headwinds in 2021, we saw economies continue the transition from rapid recovery to ongoing expansion and equity markets power through near-term risks and volatility.

As we near the end of 2021, we look back at some of the year's key economic and market developments, as well as how our portfolio allocation decisions evolved along the way (see call-out boxes).

IN THE BEGINNING, CAUTIOUS OPTIMISM

At the start of 2021, the world was in the grips of a large wave of COVID-19 infection. New cases in the U.S. numbered as much as four times their peak from the prior summer's surge, many hospital systems reported they were reaching capacity, and COVID-19 deaths were accelerating to over 4,000 per day. Still, there were reasons for optimism. The global economy was rebounding sharply from early-pandemic lows and the first COVID-19 vaccines, which had shown very high efficacy in testing, were rolling out. U.S. monetary policy was highly accommodative. Interest rates were very low, fiscal stimulus from 2020 had bolstered consumer savings, and more stimulus seemed likely. Further, the contentious 2020 U.S. election had resulted in the narrowest Senate control possible, which we believed would constrain legislative risk.

We expected 2021 would be a very good year for the U.S. and global economy, and a pretty good year for stocks. We anticipated fiscal stimulus would help bridge the gap until widespread vaccination allowed many to return to a more normal level of activity. We also expected elevated demand for goods during the pandemic would be partially replaced by a rebound in demand for services. For stocks, strong economic growth was boosting 2021 earnings growth expectations, and we saw upside to consensus estimates. In our view, this was likely to drive positive equity returns, though valuation multiple compression might keep equity returns to high single digits for the year.

Dec. 2020 - Feb. 2021

Weighing a positive outlook for economic and earnings growth against risk that low interest rates would rise, we eliminated U.S. large-cap Consumer Staples exposure across portfolios and shifted to an overweight of equities in balanced portfolios.

We underestimated. With three quarters of earnings reported, full-year 2021 EPS for the S&P 500 is now expected to grow over 45% year-over-year, according to FactSet. That is double the consensus estimate at the start of the year. As of December 15, 2021, the S&P 500 has returned over 27% year-to-date (YTD), and the spread between the best and worst S&P 500 sectors is 36 percentage points, about 4 points above the average annual spread over the 10 years pre-pandemic.

Active sector allocation and avoidance in the U.S. has benefitted relative performance across our strategies YTD. This was especially true in the first quarter, as the rapid pace of economic recovery underpinned cyclical sector outperformance and market resilience in the face of the winter COVID-19 surge, the January 6 assault on the Capitol, a second Presidential impeachment, and concerns over the tax and legislative agenda of the incoming administration.

EVOLUTION

U.S. Economy: As 2021 progressed, we saw increasing signs of the economic cycle evolving from rapid recovery to a more muted, but still strong, expansion. The unprecedented speed of the recovery brought the level of U.S. economic output, as measured by real GDP, to a new high in Q2, just a year after its pandemic low. This was due, in part, to a temporary burst of economic activity in the first half of the year as vaccination rates increased, lockdown measures eased, and many businesses hard-hit by the pandemic, such as hospitality and leisure, finally saw a material rebound in demand.

May/June 2021

Seeing an ongoing economic shift from rapid recovery to more normalized expansion, we reduced cyclical Industrials exposure and added to Info Tech and Financials in U.S. large-cap allocations, and we eliminated U.S. small-cap exposure in global portfolios, while adding to European exposure.

Many businesses struggled to keep up with surges in demand, in part due to supply chain and labor market constraints tied to pandemic disruptions. Reduced supply of computer chips was a prime example of the constraints that rippled through supply chains, impacting production of downstream goods from autos to video game consoles. Disruptions were exacerbated by the tight labor market, as the unemployment rate fell to levels previously considered "full employment" even as millions of displaced workers remained out of the workforce. We viewed these disruptions, in part, as catalysts for the typical cyclical deceleration from dynamic recovery into expansionary growth. Real GDP growth has slowed from a rebound peak of 33.8% in Q3 2020 to a 2.1% pace in Q3 2021. As the cycle has progressed this year, we have reduced exposure to the most cyclical, early-phase sectors and added to sectors we view as likely to see less earnings deceleration in the expansion phase of the cycle.

COVID-19: Unfortunately, the SARS-CoV-2 virus also evolved. In May 2021, a COVID-19 variant that had first been identified in India was christened as the Delta variant. It carried mutations that seem to make it about 50% more transmissible than the original strains of the virus. Delta quickly became the dominant source of new COVID-19 infections, kicking off a new global surge in Q3. In the U.S., rising vaccination rates (despite some persistent vaccine hesitancy) seemed to be helping the Delta variant run its course, but just as the Delta wave seemed to be ebbing, the Omicron variant has started to spread at a potentially faster rate than Delta. While the characteristics of Omicron are still unclear, we continue to see a pattern of diminished negative economic and market impact from each new COVID wave.

Inflation and Rates: Elevated inflation has been a growing market concern over the past several quarters. In Q2, the initial rise in core CPI growth year-over-year was partly attributable to base-effect in comparison to deflationary impacts early in the pandemic. Some inflationary impact was also evident from supply chain disruption, though we shared a widespread view that such impacts would be "transitory." However, we now see evidence of potentially longer-lasting inflationary pressures, including in wages and housing costs.

We have expected upside risk to interest rates from a normal rise in real rates tied to economic expansion, but increasingly it appears inflation expectations could add to upward pressure on rates. The Federal Reserve initially framed inflation as transitory, but has shifted its stance as pandemic disruptions and elevated inflation readings, near a 40-year high, have persisted. The Fed has now indicated it could end in bond purchases as early as March 2022, clearing the way for a cycle of Fed Funds rate hikes potentially sooner than was widely expected. Equity markets had shown resilience in the face of inflation concerns and the Fed's prior signaling of tolerance for elevated inflation, but also reacted positively in mid-December to news of an accelerated timeline for monetary policy tightening.

International: Outside the U.S., many of the same economic factors have been at play in 2021, though not always synchronously. Emerging Asia, for instance, was among the first regions to start its economic recovery from the pandemic, but also one of the first to see economic deceleration, particularly in China, which led emerging market equities to negative returns YTD. Europe has posted solid economic growth so far in 2021, but below our initial expectations, as it struggled in its early vaccination efforts and suffered some renewed lockdowns amid the Delta wave. We were underweight Europe throughout 2021, but increased exposure as we shifted international emphasis from emerging to developed markets.

July 2021

We continued repositioning global portfolios for evolution of the economic cycle. We shifted an overweight within Asia from emerging to developed markets, and, in balanced portfolios, reduced the average duration of our overweight of corporate bonds.

A NEW PHASE, WITH ECHOS OF A YEAR AGO

After a very good year for the global economy and equity markets, on a whole, we find ourselves in a similar position to the start of 2021, a state of cautious optimism. We expect the expansionary phase of the current economic cycle to continue through 2022, which should support continued earnings growth as a key driver of positive equity returns, despite ongoing COVID-19 risks, including a potential surge of infection from the Omicron variant. Once again, we believe sector selection will be crucial for active portfolios in the year ahead, with shifting leadership reflecting the more advanced economic environment. As always, we continue to analyze the evolving macroeconomic and market environment. We look forward to providing our formal 2022 outlook as part of our regular Q4 2021 commentary in early January.

September/November 2021

As economic growth slowed to an expansionary pace, we further reduced U.S. cyclical exposure in ETF portfolios, trimming Energy and adding to Information Technology. In global portfolios, we shifted further away from EM Asia to Europe and developed Asia.

WestEnd Advisors Investment Team | December 15, 2021