Annual Investment Update

ECONOMIC REVIEW AND OUTLOOK

DECEMBER 31, 2021

In a year that many expected to represent a clear path to recovery from the pandemic paved by readily available and highly effective vaccines, 2021 proved to be anything but clear and linear for markets, the economy, and the virus. In the infancy of the economy returning to normal, demand for goods surged, fueled by high savings rates and generous fiscal stimulus. At the same time, the supply of goods was constrained by global outbreaks, shipping issues, labor shortages, and a fragile just-in-time logistics system that broke under the strain. The virus, too, surprised the world with new variants that spread quickly across borders. Despite these challenges, growth as measured by gross domestic product (GDP) increased sharply, unemployment levels fell precipitously, and markets as measured by the S&P 500 Index soared, with the index posting its third best return in a decade.

While significant challenges still lie ahead, 2022 looks to be an above-average year for growth with resilient corporate earnings and a tailwind from people getting back to work. The Federal Reserve (the Fed) has a plan for containing worrisome inflation after nearly a decade of trying to stimulate it, and despite the new COVID variants, healthcare systems have managed to remain relatively stable.

The Economic Expansion Accelerates The year 2021 began with cautious optimism as multiple promising COVID-19 vaccines rolled out across the globe. Borders and businesses gradually reopened, and economies slowly returned to a "new normal" following a tumultuous 2020.

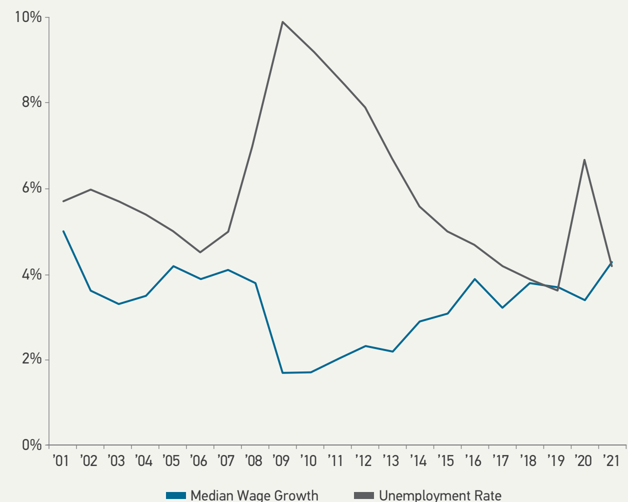
In March, the American Rescue Plan Act of 2021 was passed by the U.S. Congress and signed into law by newly elected President Joe Biden. The $1.9 trillion package included funding for state and local governments, increased jobless benefits, and sent direct checks to citizens to aid with disruptions from the ongoing pandemic. The additional spending, which built upon substantial stimulus bills passed in 2020 along with increasing vaccination rates, led economists to upgrade their 2021 U.S. growth forecasts to their highest rates in almost four decades. By the end of June, U.S. economic output surpassed its pre-pandemic level.

KEY ECONOMIC RELEASES

EMPLOYMENT	As of	Expected	Actual	Prior Period
Unit Labor Costs (3rd Quarter)	3Q	8.30%	9.60%	8.30%
Unemployment Rate	DEC	4.10%	3.90%	4.20%
Change in Non-Farm Payrolls	DEC	450K	199K	210K
INFLATION (Year Over Year)	**As of**	**Expected**	**Actual**	**Prior Period**
Consumer Price Index	DEC	7.00%	7.00%	6.80%
CPI Ex Food & Energy	DEC	5.40%	5.50%	4.90%
Producer Price Index	NOV	N/A	13.30%	12.60%
HOME PRICES (Year Over Year)	**As of**	**Expected**	**Actual**	**Prior Period**
S&P/Case Shiller Top 20 Mkts.	OCT	18.50%	18.41%	19.05%
MANUFACTURING ACTIVITY	**As of**	**Expected**	**Actual**	**Prior Period**
Capacity Utilization	NOV	76.80%	76.80%	76.40%
Leading Indicators	NOV	1.00%	1.10%	0.90%
GDP Annualized (3rd Quarter)	3Q	2.10%	2.30%	2.10%

Source: Bloomberg

UNEMPLOYMENT AND WAGE GROWTH



Source: Bloomberg

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Much of this growth came from consumers, whose spending accounts for more than two-thirds of U.S. economic activity. Broadly speaking, consumer finances were in good shape. Throughout the pandemic, many people benefited from ample government assistance, built up their savings, and/or saw the value of their homes and assets rise. The vaccine rollout and subsequent reopening allowed for the resumption of activities, such as dining out and travel, that many consumers put on hold during 2020. The pandemic also spurred new spending habits and things like home renovations and outdoor recreation saw big demand.

The housing market had another boom year as buyers were motivated by low mortgage rates, high savings rates, and, for many, a desire for a space to work remotely. Meanwhile, the supply of available homes dropped to a record low at the beginning of 2021 and remained well below normal all year. Unsurprisingly, prices rose significantly. In November, the median existing-home price hit over $350,000, a 13.9% increase from a year earlier. During the year, the number of new houses starting construction exceeded those that were completed by the largest margin since 1984. The gap reflected the strong housing demand and the struggle builders faced acquiring the materials needed to finish new homes.

Most countries saw accelerated growth in 2021. Manufacturing was particularly robust in the U.K. and Europe along with the United States. The Purchasing Managers' Index (PMI), an indicator of the outlook for conditions in the manufacturing sector, was strongly positive for these economies all year. Signaling continued confidence, equipment investment was expected to rise by 13% in the U.S. and by 3.6% in the eurozone in 2021, according to JPMorgan Chase.

Though it was the first country to seemingly normalize from the pandemic in 2020, China was one of the few nations that experienced below-trend growth in 2021. Amid the Chinese government's goals of "common prosperity" and carbon neutrality, regulation was expanded across the economy, particularly in the real estate and energy sectors. Along with sporadic lockdowns stemming from the ongoing pandemic, the restrictions hampered the country's growth for most of the year.

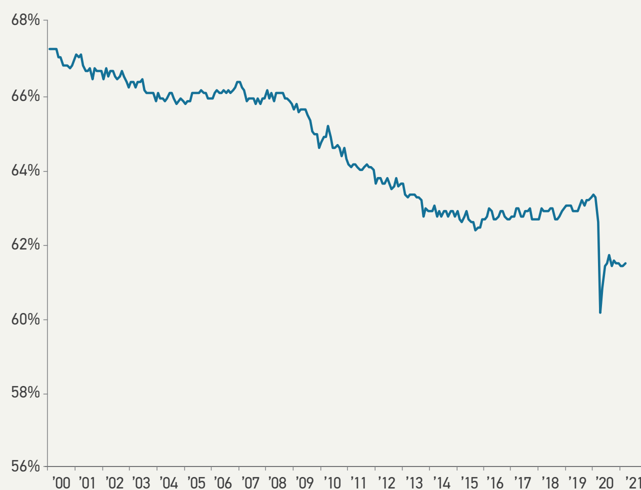
Growing Pains During 2021 the U.S. unemployment rate fell from 6.7% to 3.9%. However, the quick pace of reopening along with the considerable demand created worker shortages in numerous industries, ranging from retail and hospitality to transportation and healthcare. As of the end of October, the number and rate of job openings in the United States sat at record highs of 11 million and 6.9%, respectively. The substantial demand for labor put upward pressure on wages and, as of November, average hourly earnings had increased by 4.8% from the year prior.

Along with worker shortages, COVID disruptions mired supply chains throughout the year. Factories and ports shut down at various points and companies in crucial segments such as warehousing and trucking struggled to attract and retain workers. As major U.S. ports processed around 20% more volume than in 2019, containers piled up and ships waited weeks to dock. Consequently, buyers saw fewer options and higher prices for a broad array of goods, including cars, gasoline, semiconductors, lumber, and cream cheese, to name a few. Inflation ended the year at its highest level in decades.

Recovery Continues but Likely a Harder Path Ahead Consumers remain healthy, businesses are expanding, and there are signs that some of the supply chain strains are easing. We expect the economic expansion to continue through 2022, though the easy gains are likely behind us.

The employment environment is in better shape than it was a year ago but labor markets across the globe remain disrupted. Many countries took great pains to mitigate employment losses during the onset of the pandemic but getting enough workers back to meet demand has proven difficult. Labor force participation rates generally remain below their pre-pandemic levels. This is particularly acute in the United States, where around 3 million Americans have retired—the biggest contributor to the decline in labor force participation since the pandemic started.

U.S. LABOR FORCE PARTICIPATION RATE



Source: Bloomberg

BOND MARKET REVIEW AND OUTLOOK

DECEMBER 31, 2021

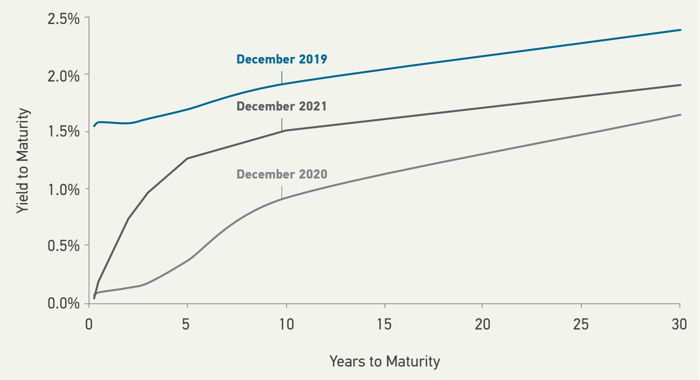
A Year of Transition Bond markets, as measured by the Bloomberg Intermediate U.S. Government/Credit Bond Index, dropped 1.44% as interest rates broadly moved up across the yield curve, decreasing the value of low-yielding bonds but providing better future buying opportunities to generate income.

The extraordinary fiscal and monetary efforts to combat the financial impacts of the pandemic were wildly successful at instilling confidence in the markets and bridging the gap between "flattening the curve" and "returning to normal." The Federal Reserve spent much of 2021 preparing markets for the idea that those extraordinary measures are coming to an end. Bond markets, in turn, spent the year anticipating the impacts of the end of accommodative monetary policy as well as examining the inflationary impulse from excess liquidity and direct fiscal stimulus.

Here Comes Inflation Early in 2021, as vaccines rolled out and another round of fiscal stimulus dollars arrived in bank accounts, consumers eagerly increased their personal consumption accordingly. This growth in demand was mismatched with global supply constraints caused by shipping issues, labor shortages, factory shutdowns due to the pandemic, and various vulnerabilities of a supply chain that depends on a smoothly functioning economy. The mismatch caused a significant spike in inflation from 1.4% in January to 4.2% by April and sent 10-year bond yields soaring from 0.91% to 1.72% during the same period. As it became evident over the summer that the vaccination program would not proceed as quickly as hoped and that variants posed a risk to the global economy, yields fell back sharply even as inflation continued to surge. The year closed with 10-year U.S. Treasury bond yields at 1.52%, a shockingly low number for a market with an inflation rate at 6.8%. Bond markets appear to be pricing future inflation at significantly lower levels than we've experienced toward the end of 2021.

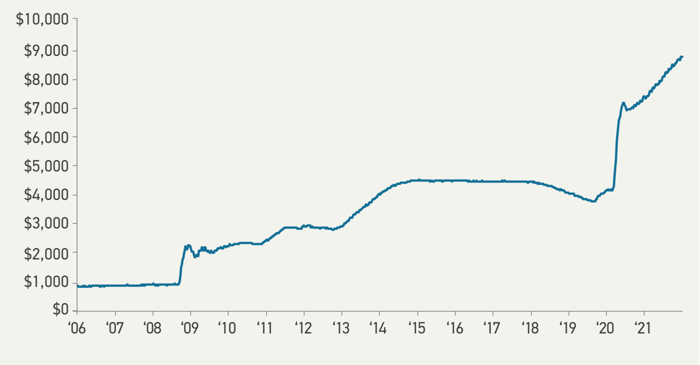
How persistent or "transitory" inflation proves to be will determine the outlook for the bond market. The Fed spent much of the year arguing that the underlying causes of inflation were self-correcting and required no intervention. As inflation morphed from a supply/demand mismatch to an entrenched phenomenon that was impacting contract-based pricing, wages, and rents, the Fed began to communicate to the market its intention to address the issue. The Fed's two primary tools to moderate inflation are asset purchases, commonly known as "quantitative easing," and interest rates. During its November meeting, the Fed announced a "taper"

U.S. TREASURY YIELD CURVE



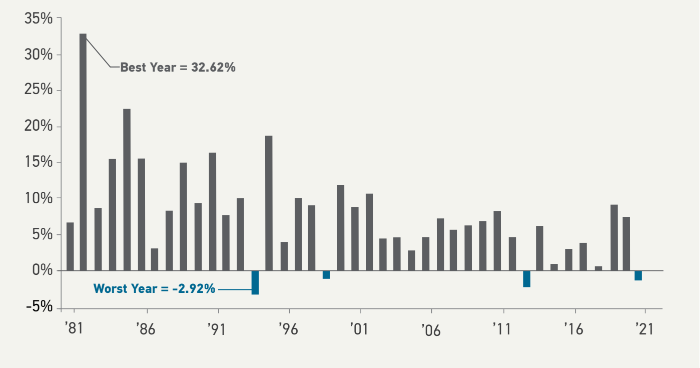
Source: Bloomberg

VALUE OF ASSETS HELD BY THE FEDERAL RESERVE - IN BILLIONS



Source: Bloomberg

BOND MARKET CALENDAR YEAR RETURNS 1981–2021



Source: Bloomberg

BOND MARKET REVIEW AND OUTLOOK (CONTINUED)

of the pace of bond buying, equivalent to taking its foot off the gas to decelerate the economy. The market now widely anticipates an end to quantitative easing in the spring, followed shortly thereafter by interest rate increases, or pressing on the brake to slow the economy. After nearly a decade of fighting deflationary pressures with novel tools, this is more familiar territory for the Fed and it appears confident in its ability to address inflation.

Federal Support for State Debt Municipal debt continued to perform well in 2021 with the support of the federal government through the American Rescue Plan as well as the Infrastructure Investment and Jobs Act, both signed into law during the year. Muni bonds were up 1.52% as measured by the Bloomberg Municipal Bond Index, the eighth consecutive year of positive returns as the insatiable appetite for investments that are exempt from taxes drove investors to the asset class. Investors anticipate higher taxes in the future to pay for increased spending from the pandemic and have accepted low yields to shelter their income.

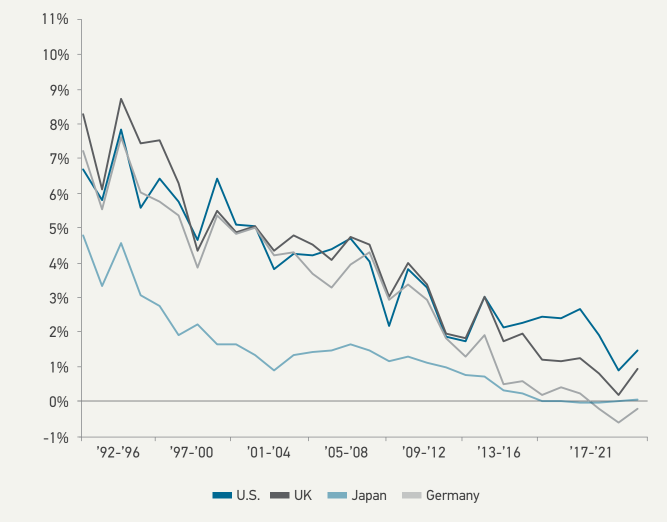
High-yield debt, as measured by the Bloomberg U.S. Corporate High Yield Index, rose 5.28% during the year, helped by a higher oil price that provided good cash flows to heavily indebted oil exploration companies. Spreads, or the interest rate that these companies must pay above what the U.S. Treasury yields, fell from 3.59% to 2.83% during the year as the market gained confidence that corporate profitability was strong, and debt could be repaid.

The outlook for bonds remains uncertain heading into 2022 with significant interest-rate risk from Fed policy and high inflation, but fairly low credit-rate risk as companies remain highly profitable and financially sound.

CONSUMER PRICE INDEX (CPI) YEAR OVER YEAR

Source: Bloomberg

10-YEAR BOND YIELDS OF MAJOR DEVELOPED ECONOMIES



Source: Bloomberg

STOCK MARKET REVIEW AND OUTLOOK

DECEMBER 31, 2021

A Banner Year for Stocks On the back of a firmly recovering economy, U.S. stocks had another stellar year. The S&P 500, an index that measures the performance of the 500 largest U.S. companies, hit an astounding 70 record highs in 2021. The index ultimately returned 28.68% for the year.

Investors had reason to be enthusiastic. Though companies battled with supply chain disruptions and shortages, among other pandemic-related issues, they found ways to remain profitable. Overall, corporate earnings exceeded already upbeat estimates every quarter. Net profit margins soared 40% from 9% in mid-2020 to an all-time high of 13% in the second quarter of 2021. Even those highly impacted industries, such as home builders, reported some of their highest profit margins ever, despite paying record prices for lumber and other supplies. Share repurchases by companies in the S&P 500 hit an estimated record of $850 billion, up over 16% from 2019 after many paused these programs in 2020.

Developed international markets lagged behind the United States but still posted positive returns of 11.86%, as measured by the MSCI EAFE Index. While Chinese markets suffered, other emerging economies such as Vietnam, Taiwan, and India saw strong market performance.

A Reversal of Trends After several tough years, energy was the best-performing sector, up 54.64% for the year. Given the significant global demand, oil prices rose to their highest levels in seven years, and expectations for energy companies to profit rose accordingly.

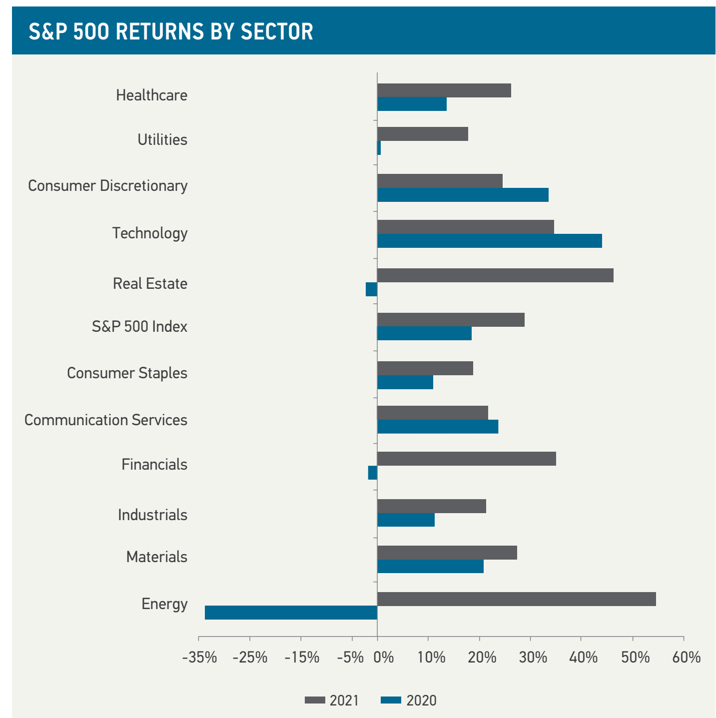
The real estate and financial sectors were the next best performers, up 46.19% and 35.04%, respectively. Though the recovery in the real estate markets was uneven, segments that support the digital economy, such as logistics centers, warehouses, data centers, and cell towers, experienced booming demand in 2021. Investors also bought financial stocks as expectations for higher interest rates took hold. Most financial institutions benefit as interest rates rise and their net interest margins (the difference between interest paid on accounts and interest received from borrowers) increase. Large banks also had healthy balance sheets, as reflected by the Federal Reserve's annual stress test, which allowed them to increase their dividends.

Driven by the growing dependence on online solutions for both work and home lives, the technology sector remained a winner throughout the pandemic. Utilities were the worst performing, though still up 17.67%, as investors sought out more attractive growth opportunities.

STOCK MARKET RETURNS	Latest Quarter	12 Months	Last 3 Years
S&P 500	11.02%	28.68%	26.03%
Russell 1000 Growth	11.64%	27.59%	34.04%
Russell 1000 Value	7.75%	25.12%	17.60%
S&P 400 MidCap	7.97%	24.73%	21.36%
MSCI Developed (EAFE)	2.74%	11.86%	14.17%
MSCI Emerging Markets	-1.36%	-2.47%	11.23%
Alternative Assets			
Bloomberg Commodity	-1.58%	27.05%	8.93%
MSCI World Real Estate	10.95%	29.54%	15.40%
S&P Global Infrastructure Index	4.58%	11.75%	10.14%

Source: Bloomberg

S&P 500 RETURNS BY SECTOR



Source: Bloomberg

STOCK MARKET REVIEW AND OUTLOOK (CONTINUED)

A New Environment for Business in China Chinese stocks were hurt amid China's rising tensions with the United States and concerns of potential delisting from U.S. exchanges—which would make it harder for Americans to invest in these companies. Large Chinese internet stocks, often listed and highly traded in the U.S., particularly suffered.

The internal regulatory push by the Chinese government also imposed costs on many businesses. As the government was seeking to rein in excessive borrowing by developers, Chinese real estate giant Evergrande ran into problems in September as it faced defaulting on payments due on its substantial debt load. Evergrande's troubles kept investors worldwide anxious that the company's collapse could have run-on effects for the entire global financial system. In 2021, China was the second-largest economy and its property market accounted for a quarter of the country's GDP.

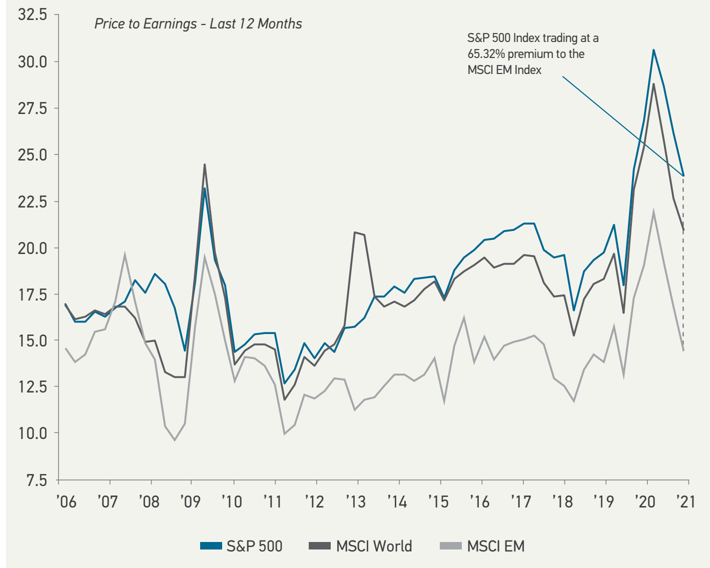
The new regulatory environment in China is anticipated to persist as the government continues to develop policies intended to shift the economy from growth driven to quality focused and more sustainable. While the initiatives harmed some companies and sectors, they are expected to provide opportunity for others.

Uncertainty Expected but with Constructive Underpinnings While 2021 was a relatively rosy year for the stock markets, 2022 may see more turmoil. Financial markets remain quite sensitive to the COVID positive testing rate and new variants or further spread of the virus could give investors pause, as we saw with the Delta and Omicron variants in 2021. Furthermore, as the Federal Reserve navigates its publicized course of tapering and eventual rate hikes, markets will likely be quick to react to any change in plans.

Additionally, of the four years in a presidential term, the midterm election year tends to be positive, but the rockiest, for markets. Regardless of which political party eventually wins, midterm elections present uncertainty. As the election nears, the possibility for a change in direction, whether through fiscal policy or regulatory focus, can bring about volatility in the markets.

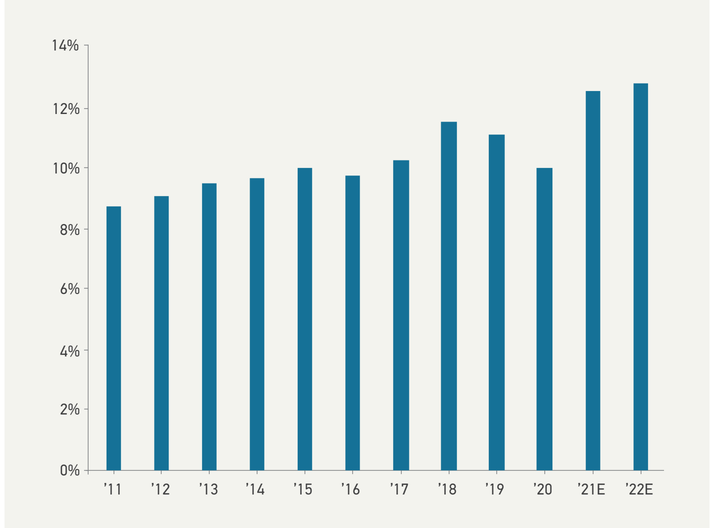
That said, companies with strong balance sheets and experienced managements have performed well during the recovery from COVID-19 and analysts expect net profit margins will remain elevated as we head into 2022. Many companies are cash flush and have indicated they plan to spend on share buybacks and dividends. The continued economic expansion globally should also support stocks in the new year.

U.S. VS. INTERNATIONAL VS. EM VALUATIONS



Source: Bloomberg

S&P 500 NET PROFIT MARGIN 2011-2022



Source: FactSet

INVESTMENT MANAGEMENT SERVICES

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INVESTMENT PROCESS

1. **LEARN** CLIENT GOALS & NEEDS
2. **ESTABLISH** CLIENT INVESTMENT OBJECTIVE & STRATEGY
3. **DETERMINE** ASSET ALLOCATION STRATEGY
4. **CONSTRUCT & MONITOR** INVESTMENT PORTFOLIO
5. **REVIEW & REASSESS** CLIENT NEEDS

TRUST COMPANY SERVICE

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Annual Investment Update

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