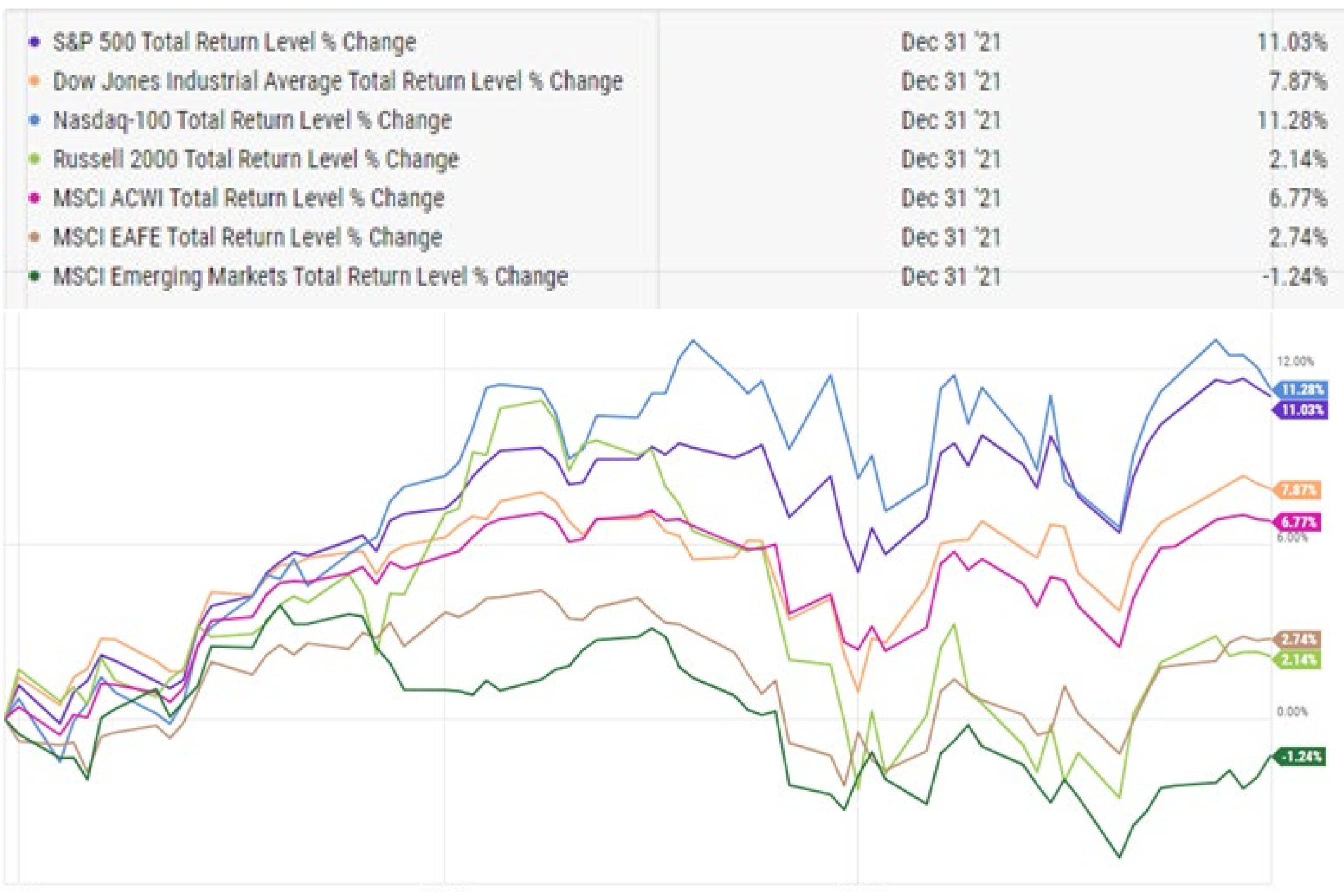
The final quarter of 2021 could be characterized with the same words that would describe the entire market year – turbulent headwinds with strong underlying momentum. As the new Omicron variant spread rapidly through the population (and media), consumers and investors seemingly balanced previously held fears of incoming lockdowns with confidence in the vaccine and boosters.

Markets

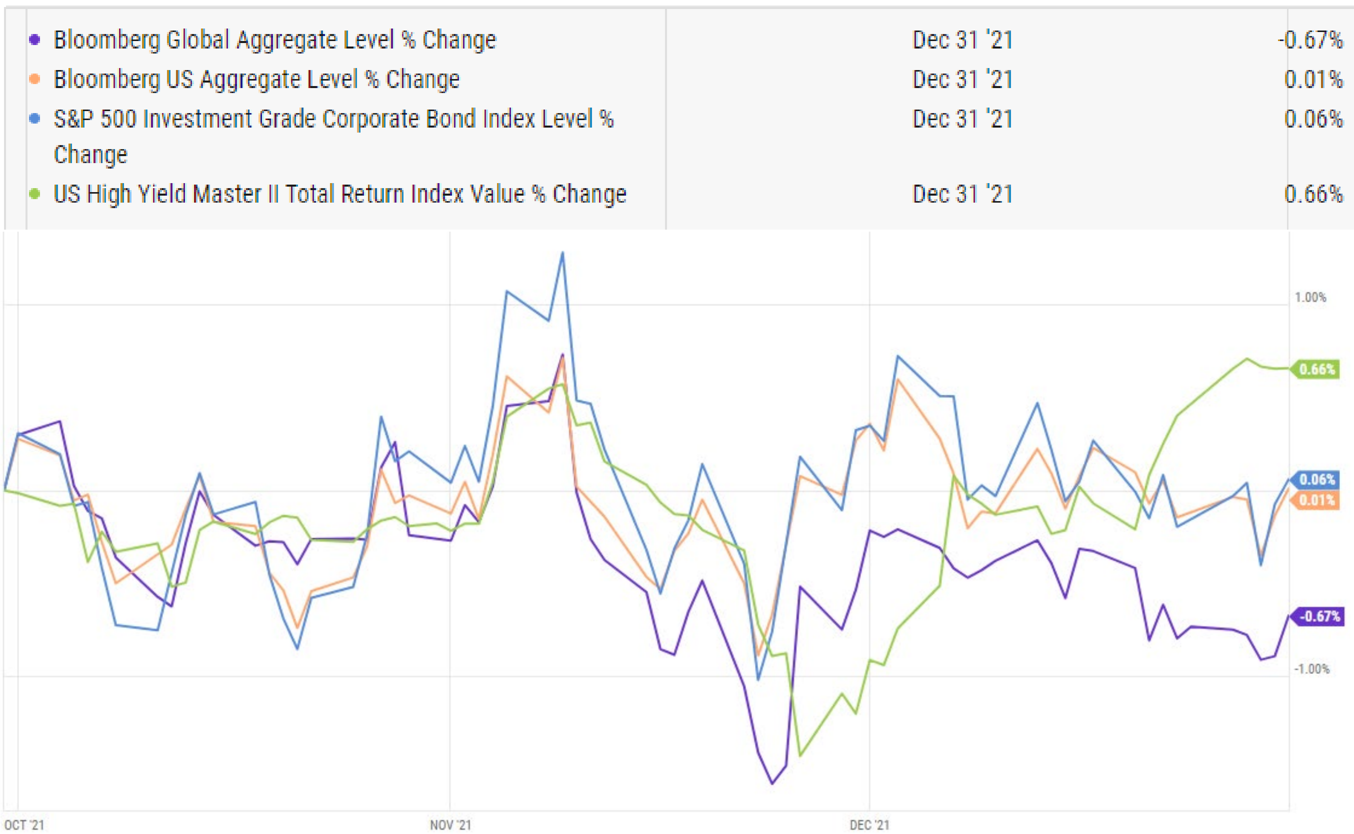
For the three months ended December 31st, domestic large-cap indices continued to lead the pack as the Nasdaq 100 ended the quarter up 11.28%, with the S&P 500 following closely behind at 11.03%. The Dow Jones Industrial Average lagged after gaining a healthy 7.87% while small caps continued to fall behind, with the Russell 2000 ending the final quarter up just 2.14%. Internationally the market saw some recovery in developed equity markets, as the MSCCI ACWI index ended the three-month period up 6.77%, while the MSCI EAFE index ended up 2.74%. The divergence between the developed and developing portions of the equity space continued as the MSCI Emerging Markets index ended the period down 1.24%, the only observed index to end the period in the red.



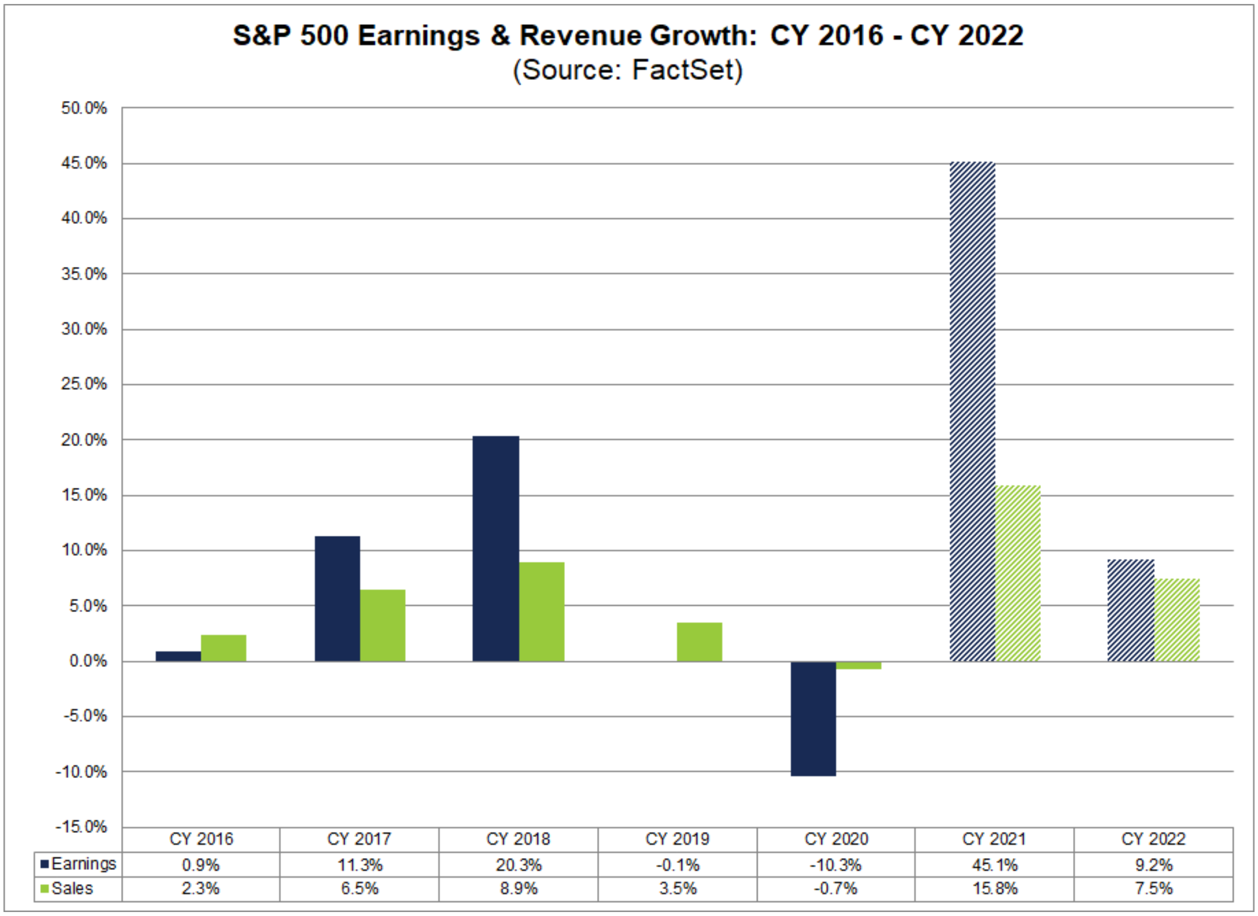
(Source: YCharts)

Turning to the fixed income market, the yield on the 2-year Treasury note began at 0.27% before ending the quarter higher at 0.73%. The longer-dated portion of the curve rose slightly compared to the front-end, as the yield on the US 10-Year began the quarter yielding 1.48%, fluctuating in the range of 1.41 – 1.68% before ending the quarter in the middle of its range at 1.52%.

The Bloomberg U.S. Aggregate and Global Aggregate continued to diverge during the final quarter, as the Global Aggregate ended down 0.67% while the US Aggregate ended the period basically flat, up just 0.01%. On the corporate side, a strong fourth quarter for higher-yielding bonds added to the performance gap between the investment grade counterparts. For the period, the US High Yield Master II Total Return index gained 0.66% while the S&P 500 Investment Grade Corporate Bond Index gained 0.06%.



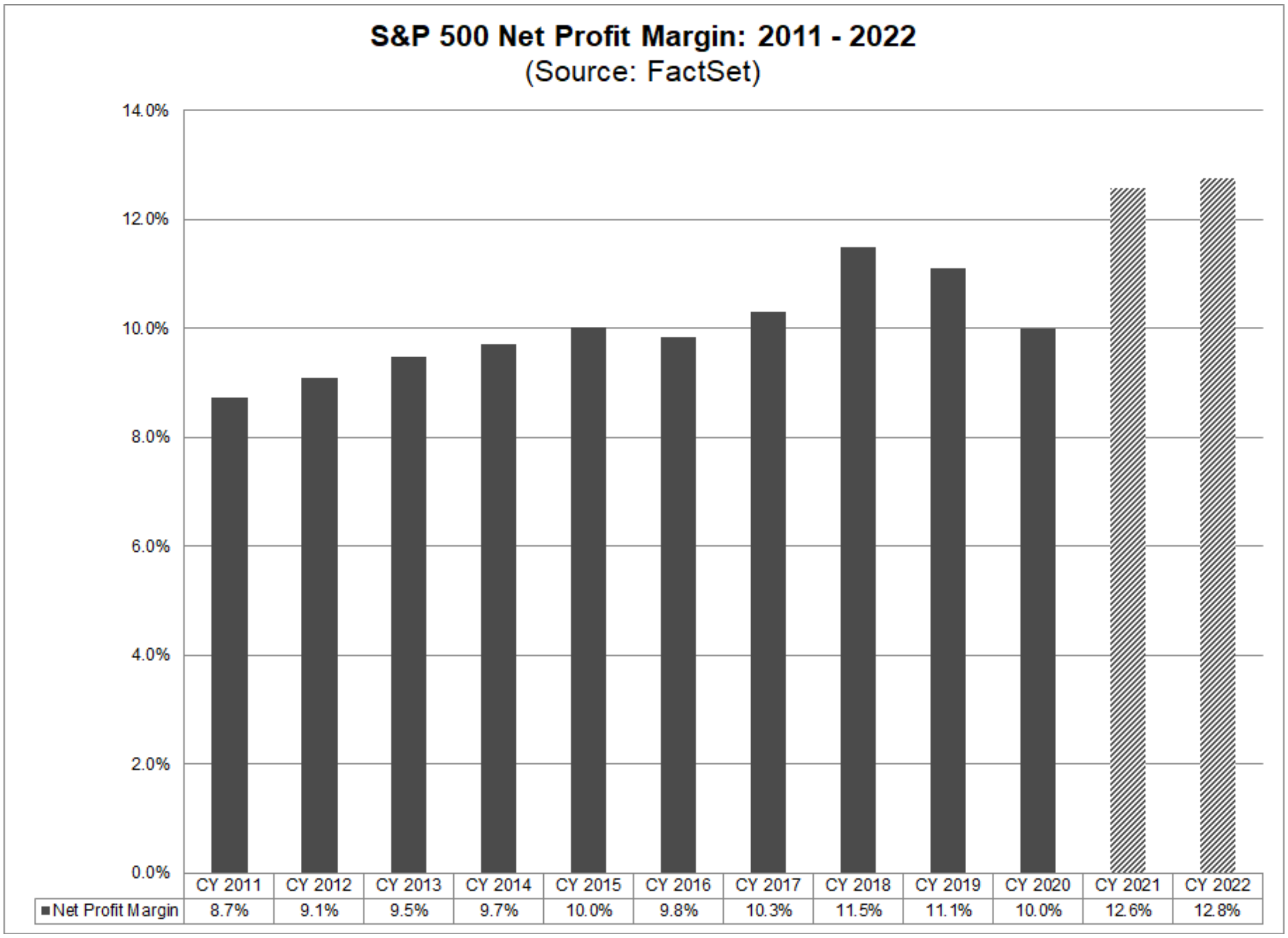
Regarding corporate earnings, the final quarter of 2021 is expected to end on a historically stronger note. Partially due to easier comparisons with the previous year, in addition to strong consumer and business demand coming back online, CY 2021's S&P 500 earnings growth rate is estimated by FactSet to be a staggering 45.1%. If this number proves to be true, it will mark the largest YoY earnings growth rate for the index since FactSet began tracking the metric in 2008, breaking the previous record holder of CY 2010 which came in at 39.6%.



Building into this historically strong year, all 11 of the observed sectors within the S&P 500 reported both earnings and revenue growth. On a sector basis, the Industrials sector earnings growth lead the way with an estimated 97.8% YoY growth rate. Within this sector, the Airlines industry is expected to be the largest contributor to earnings growth, noting that if this industry were excluded from the calculation the earnings growth rate for Industrials would fall from 97.8% to 43%. Interestingly, even though the Energy sector is expected to report huge earnings growth of $77.6bn, due to the reported CY 2020 loss of $5.2bn in earnings, a growth rate is unable to be calculated.

While it is easy to get lost in the rosy numbers reported thus far, it is important to analyze underlying margins as companies continue to grapple with persistent problems such as labor shortages, supply chain issues, and higher inflation. However, even when discussing the Index's net profit margin, growth and underlying momentum are still apparent to us with the index expected to report a margin of 12.6%.

Similarly with earnings, if this number proves to be true, it will mark the highest annual net profit margin since FactSet began tracking the metric in 2008, breaking the previous record of 11.5% which occurred in CY 2018.



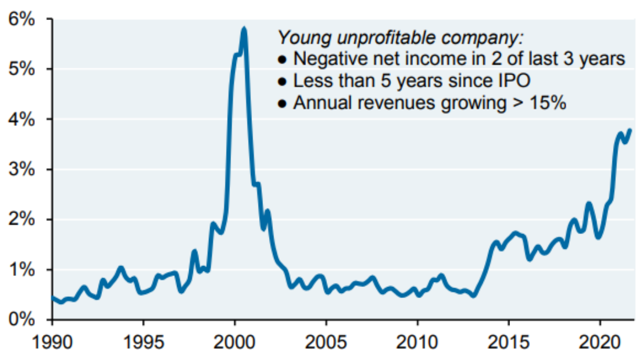
Looking ahead to 2022, JP Morgan expects 10-14% earnings growth for the S&P 500 as trend growth returns and the Federal Reserve begins to raise rates. This would be a similar market movement to that which was seen in 2021, as P/E multiples contracted and delivered an estimated total return of 7-10% including dividends.

During 2021, earnings for the index rose 36% while P/E multiples fell by 6.1%. Interestingly, despite the rising labor, intermediate goods, and raw materials costs, S&P 500 profit margins defied analyst expectations and rose as compared to pre-pandemic levels (12.3% in Q3 2021 vs. 11% in 2019), showing many companies simply passed these cost increases on to consumers. The more near-term period will not likely prove to be as easy, as JP Morgan expects input cost increases to prove more challenging for companies in the New Year, estimating that margins may fall by 1% back to 2017-2019 trend levels. JP Morgan goes further to caution investors to “be prepared for intermittent selloffs” as market fundamentals are less favorable than they were last spring.

Bridgewater estimates that there is currently $200bn of young and unprofitable companies comprising the market, the largest share of market cap since 1999. Another development they note that has not occurred since the 90’s is the behavior of certain “crowded-trade stocks,” highly-valued companies which fell by more than 35% during 2021, which is unusual for a year when market returns were ~25%.

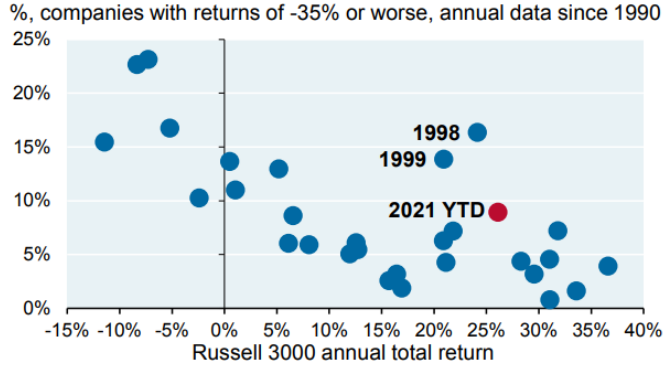
Speaking more on fundamentals, a rising number of companies are now more sensitive to changes in liquidity conditions and monetary policy than their counterparts that are more sensitive to changing economic growth. In summation, any market environment in which there is a high concentration of S&P 500 market cap and total return that is reliant on a handful of stocks is one in which investors should tread lightly.

Market cap of young unprofitable companies
% of total market cap



Source: Factset, J.P. Morgan Asset Management. Q3 2021.

Share of poorly performing stocks vs overall market return
%, companies with returns of -35% or worse, annual data since 1990

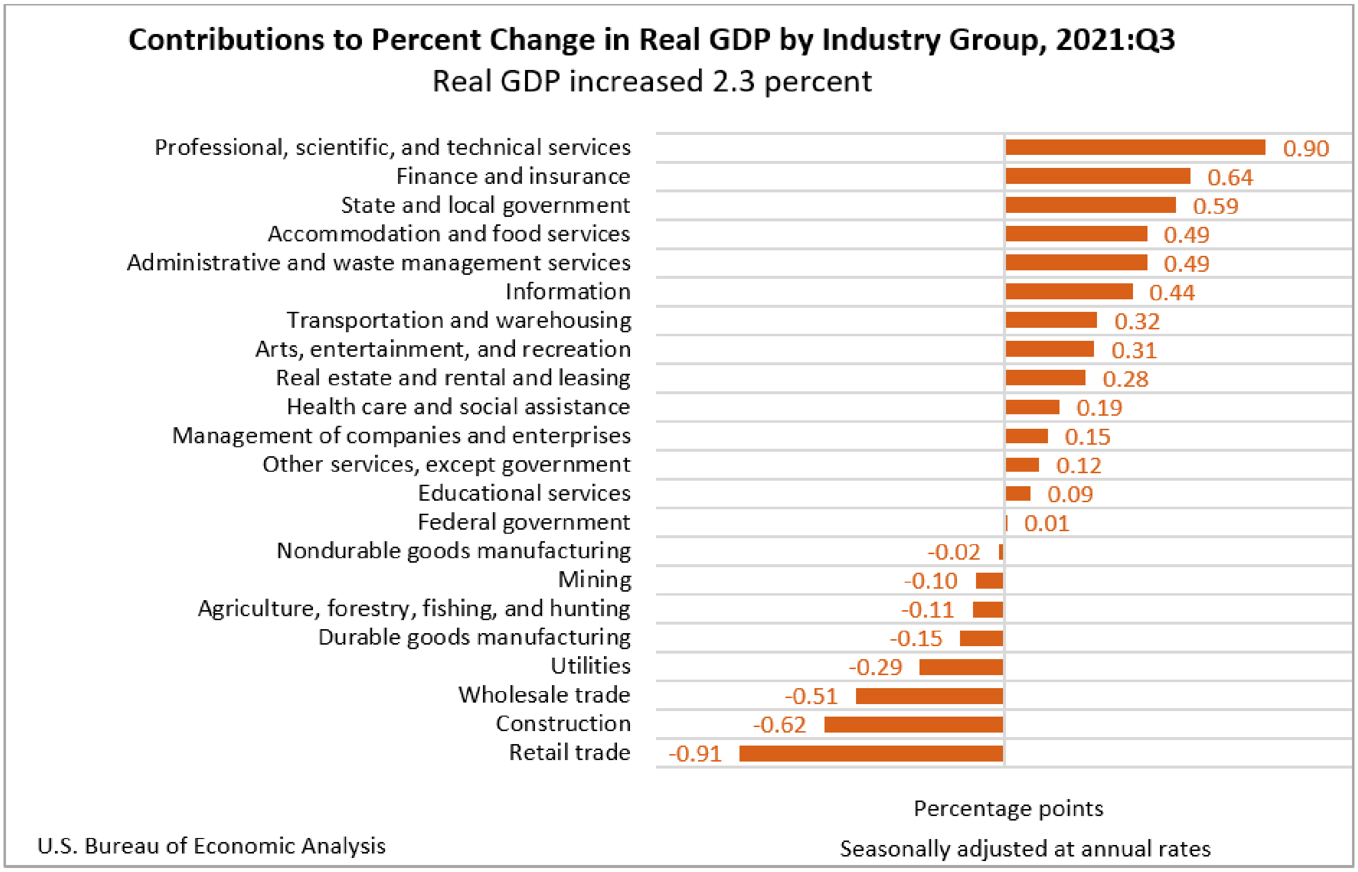


Source: Factset, Bloomberg. December 28, 2021. Includes top 50% market cap companies of the CRSP Index of US large, mid and small cap stocks.

US Economy

Looking back at the most recent estimate for GDP growth from the Bureau of Economic Analysis (BEA) in the third quarter of the year, we saw an upwards revision of 0.2% from the previous estimate to a 3Q21 annual growth rate of 2.3%. While this number is in line with historical observations seen prior to the pandemic, it marks a significant slowdown of the recovery momentum seen in the second quarter of the year which saw GDP grow 6.7%. This slowdown is an accumulation of several COVID-19 related complications. Primarily, the slowdown reflected a resurgence of COVID-19 cases which resulted in new restrictions and delays in the reopening of establishments in some areas of the country.

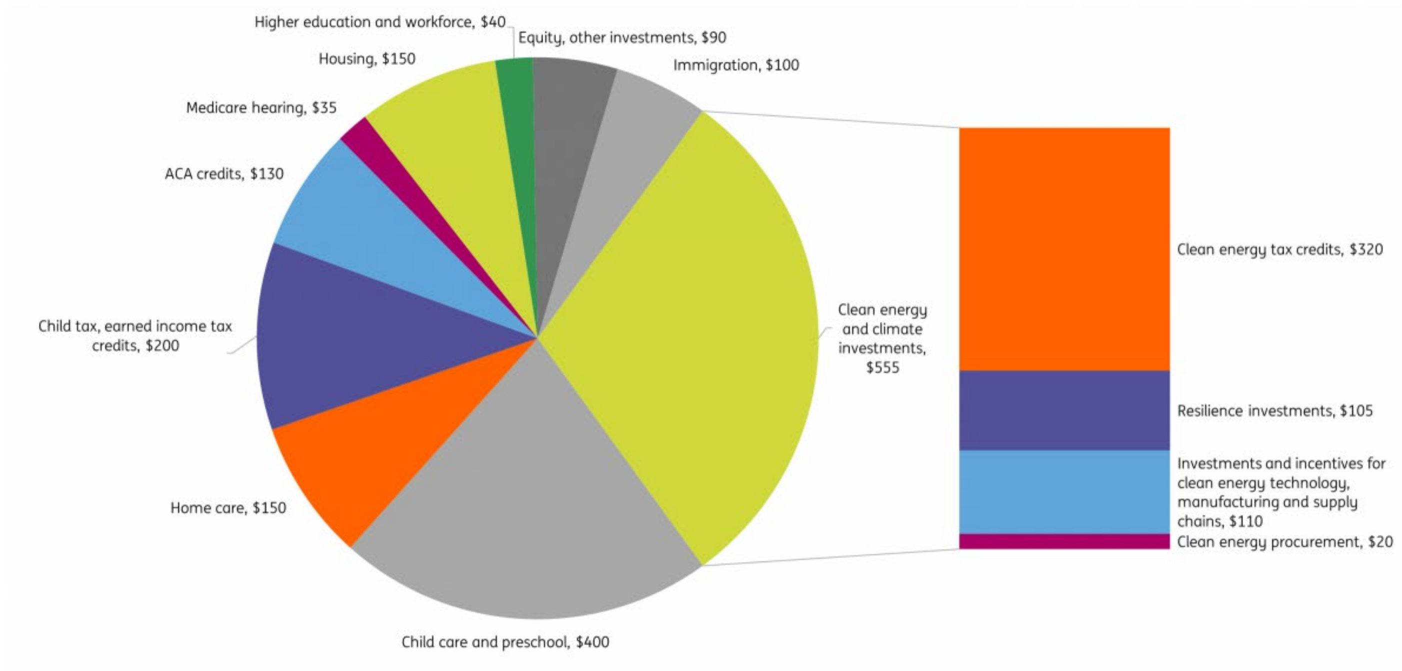
However, this slowdown also shows the impact of the continued decrease in government assistance payments in the form of loans and grants to businesses and municipalities, in addition to the decrease in social benefits to households. These two factors contributed to a slowdown in personal consumption expenditures (PCE), which more than accounted for the deceleration in real GDP growth. PCE declined primarily due to a slowdown in spending for goods (led by motor vehicles and parts) and services (led by food services and accommodations).



Looking forward, The Conference Board (CB) estimated in December that US real GDP growth will rise to 6.5% (annualized) in Q4 2021, with a CY 2021 GDP growth rate of 5.6%. Longer term, the organization projects 3.5% growth for 2022 and 2.9% growth for 2023, which reflects an upgrade for growth in Q4 2021 but a downgrade in 2022 growth estimates.

This upgrade in Q4 2021 GDP growth reflected stronger than expected economic activity in October and November, with strength likely to moderate early in 2022 due to the anticipated “winter wave” of COVID-19 resulting from the Omicron variant. In addition, the body notes persistently high inflation and a more hawkish Federal Reserve will also create headwinds for near-term economic growth outlooks. Importantly, while the CB’s estimate does include spending associated with the bipartisan infrastructure package, it does not incorporate the Build Back Better (BBB) social and climate package. As the size, composition, and timing of BBB are still uncertain, as is Congress’ ability to pass the package, analysts are weary to include it in such forecasts. If, however, the version of the bill reviewed by the Congressional Budget Office is passed and implemented in Q1 2022, CB estimates that outlays would begin in Q2 2022 and that GDP growth in 2022 would rise an additional 0.4%, noting that inflation rates would also tick up in 2022 and 2023.

Breakdown of the $1.75tn Build Back Better spending framework (in $bn)

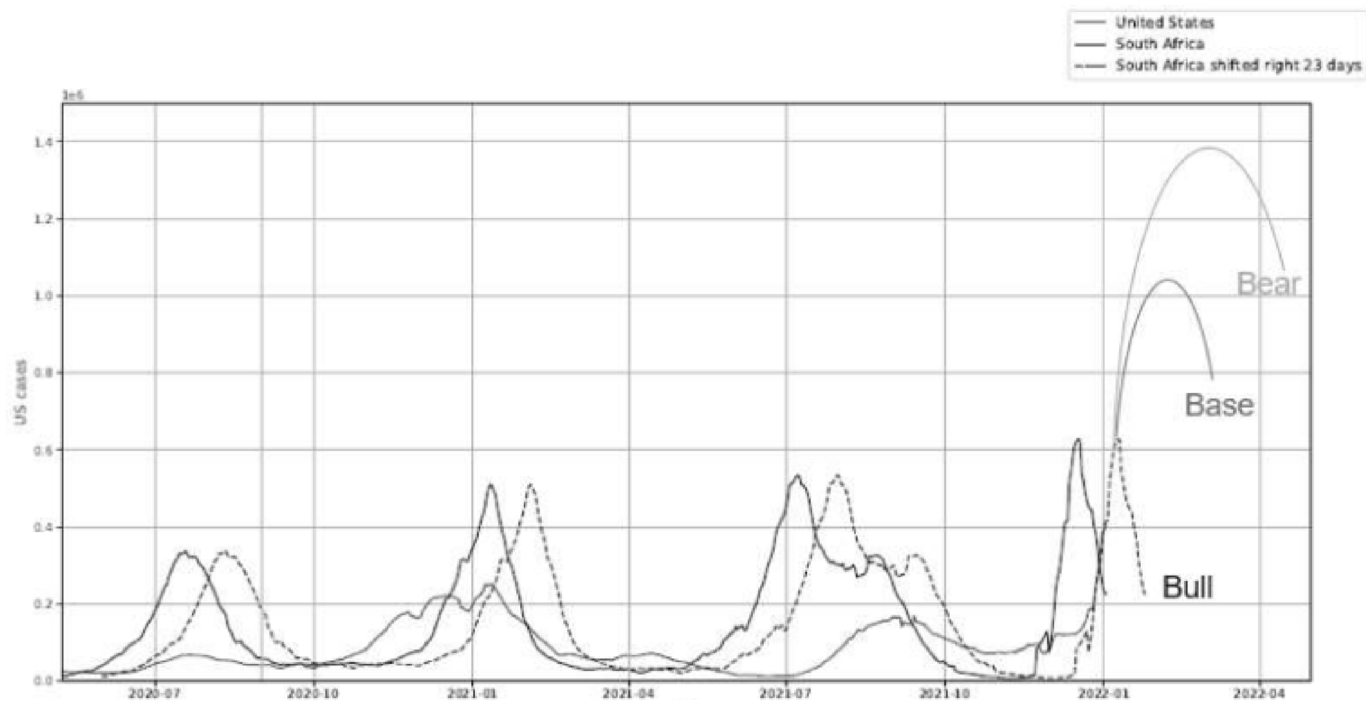


White House, Washington Post -

Taking a moment to step back and analyze the current wave of COVID-19 fueled by the rise of the Omicron variant, we look to a recently published research article from Morgan Stanley which uses South Africa as a gauge to see where the US may land when the dust settles. As the world gets more data from South Africa and Europe, Morgan Stanley has updated their base case scenario, such that Omicron will peak in 3-6 weeks with daily cases around 1mn. A large, infected population with the highly transmissible variant will eventually decrease the transmission rate, which could be what caused the rapid decline in South African cases. For example, it took South Africa 4-5 weeks to reach peak cases, which is significantly faster than the Delta variant wave which took approximately 9 weeks to peak.

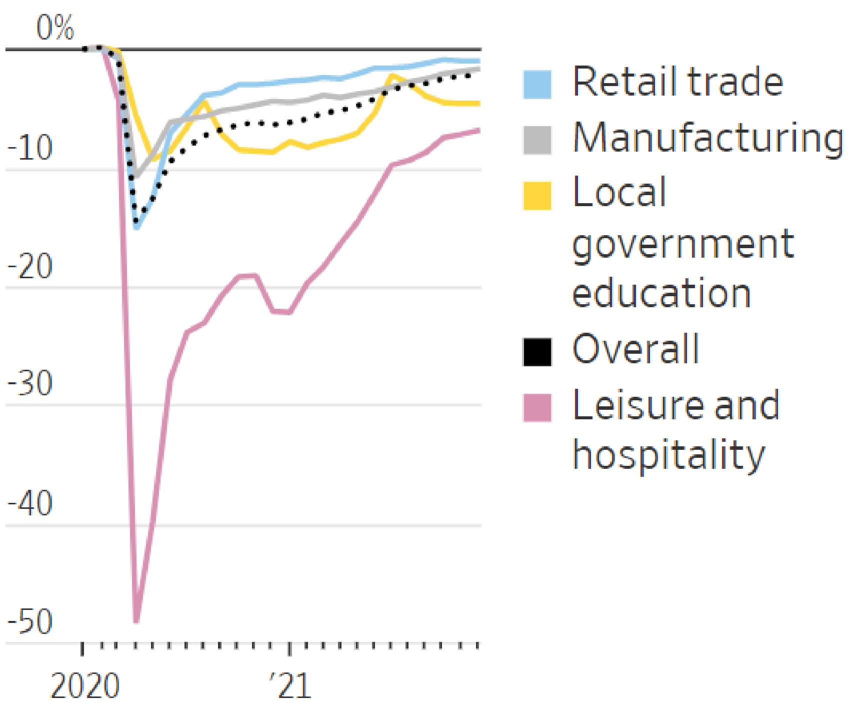
However, looking at Europe, this prediction is not so clear. In the UK, the Omicron spread is still accelerating, and the transmission rate has not yet reached its peak. To account for this divergence in country trends, Morgan Stanley lays out three cases – a bull, base, and bear case. The bull case assumes the US follows the South African trajectory closely, with transmission rising quickly and Omicron peaking in 1-2 weeks. Peak daily cases would be around 3.5-4.5x greater than the delta wave, or a 600-700k daily domestic case rate. The bear case assumes transmission rates reach an elongated plateau (similar to what is being observed in Denmark), with Omicron peaking in 1.5-2 months and peak daily cases reaching 8-10x greater than the Delta wave. Somewhere in between those two, the bank's base case assumes Omicron transmission decreases at the same rate of the Delta variant, with cases peaking in 3-6 weeks and peak daily cases reaching 6-7.5x higher than during the Delta wave.

Exhibit 1: Daily cases and Rt value in United States and South Africa



Finishing the domestic recap with the labor market, the economy has made tremendous strides in recovering the jobs lost at the onset of the pandemic. While the December job gain as posted by the Labor Department signaled some cooling amid disruptions caused by the Omicron variant, adding 199,000 jobs as compared to November's gains of 249,000, a more intermediate-term look at the labor market shows some serious recovery. For the final quarter of the year, total job gains were close to 1.1 million. In total, the US economy added about 6.4 million jobs in 2021 as compared to the end of 2020, more than any year on record. On an industry basis, retailers and manufacturers are close to fully recovering the jobs lost from the pandemic, while leisure and hospitality employers are still 7% below pre-pandemic levels. While the labor market is entering the new year on much stronger footing than it did last year, with job openings surging to historic highs, workers are still quitting their jobs at historic rates and labor force participation remains below its pre-pandemic levels (61.9% in December compared to 63.4% in February 2020). For the year, the unemployment rate fell from 6.7% to 3.9%, a shortfall of 3.9 million jobs as compared to pre-pandemic levels where the unemployment rate sat at the 3.5% level.

Payrolls by sector, change since January 2020

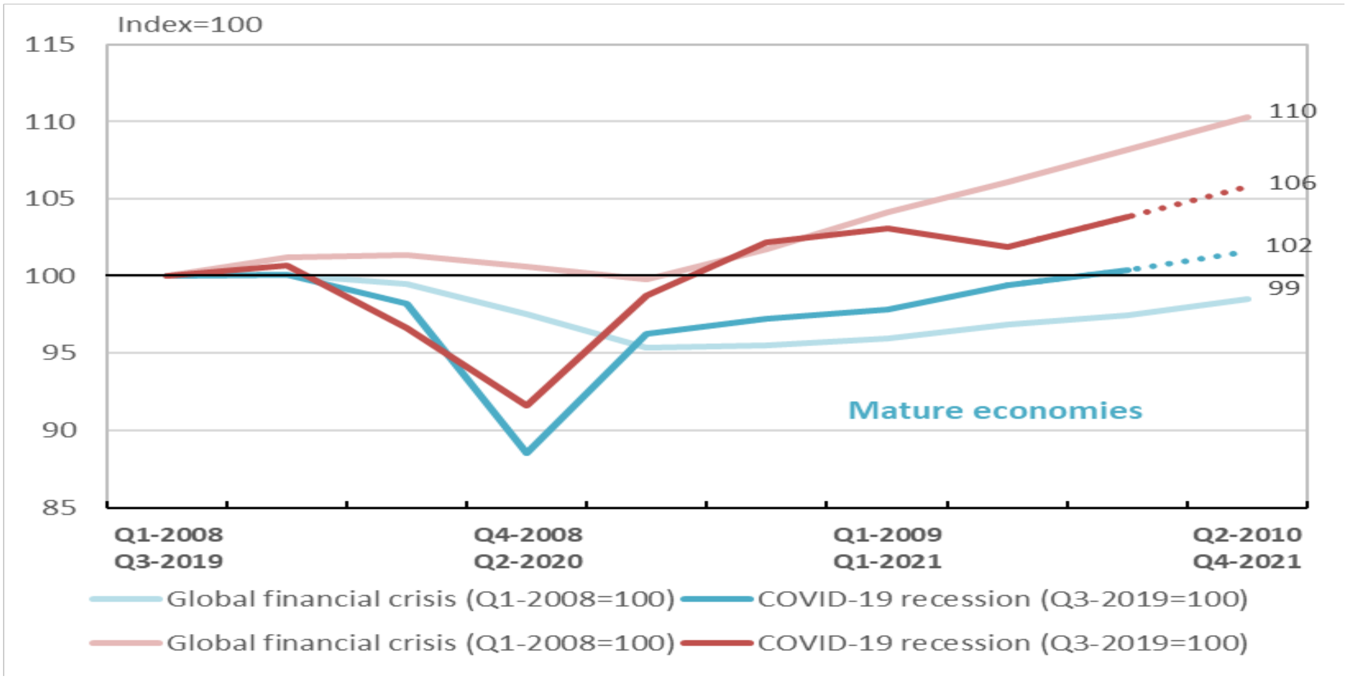


Note: Seasonally adjusted
Source: U.S. Labor Department

US Economy

Turning to the global economy, the Conference Board estimates a continuation of the above long-term trend real GDP growth in 2022, during which the organization estimates growth will reach 3.9% YoY, with growth moderating to an average annual rate 2.5% over the next decade. This near-term growth will likely be led by continued expansions in the US and Asia, though elevated global inflation is likely to muddy these waters. These inflation pressures, which have been particularly intense in commodities markets, are likely to persist through 2023 as supply-chain disruptions caused by the pandemic add to already existing cost pressures such as changing demand mix, labor shortages due to aging populations, a continued imbalance of demand and supply for microchips, and deglobalization. In response to these inflationary pressures, the CB notes that although the overall monetary stance is still broadly accommodative, even in most emerging market economies, central banks around the world are shifting towards more hawkish stances

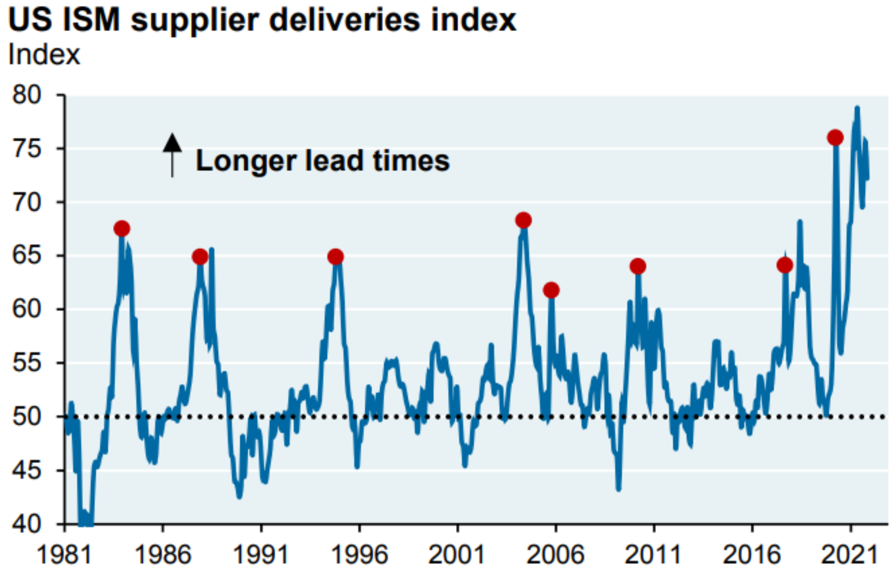
In total, the report summarizes the organization's outlook by stating that the severe pandemic-induced contraction may leave a lasting impression on global growth. While this growth is expected to return close to, but not higher than, previous projections made prior to the pandemic, factors that have largely driven global growth over the past two decades are expected to weaken substantially over the next decade. These factors – including the greater supply of labor and fast growth in capital stock to worker ratios – will only be partially offset by a shift towards qualitative growth sources such as digital transformation, productivity improvements, and long-term investments in physical and social infrastructure.



Given the current environment, it would not be a true economic recap without paying some credence to inflation. A JP Morgan article notes that global inflation is close to the highest level in 20 years, driven by a multitude of items. Surging goods prices, changing consumption patterns, the inability of a just-in-time corporate sector to respond, soaring government debt, and energy policies which reduce the supply of thermal energy faster than they reduce the demand are all leading to the price increases most consumers are now facing. In all, the report notes, the global supply chain is more of a consequence of surging demand than that of weak output, which is a silver lining in the cloud of inflation. Importantly, global goods production, world exports, containerships in service, and port throughput are all well above trend, alluding to an eventual ease in the supply chain crunch.

In times of unprecedented events, it is often helpful to look back at history to get an idea of what is to come. Given that since 1980 there have been 8 such cases of supply shocks, all of which were resolved within a few months, there is light at the end of the tunnel in our opinion. Obviously, the current supply crisis has been ongoing for longer than a few months, but given the complications of COVID-19 not present during the previously mentioned 8 instances this is more than expected. Considering such items like planned capital spending in areas such as transportation and semiconductors, the team at JP Morgan expects current supply chain problems to be resolved in 2022 and 2023 through vaccination, more capital spending, and a continuation of a shift in spending from goods back to services.

In summation, we believe the domestic and international economies will continue to grow at an above-trend-but-moderating rate, as will inflation. From a strategy perspective, we are still bullish on risk assets like equities and credit and are bearish on interest rate risk (duration). We believe economic, corporate (earnings), and consumer fundamentals will remain solid, buoying equity and credit markets.



Source: Bloomberg, JPMAM. Nov 2021. Red dots = start of supply disruption

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