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PERSPECTIVES

FOURTH QUARTER REVIEW

The Stock Market Turned in a Solid Performance in 2021.

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Happy New Year! As we turn the page on the calendar, we once again reflect on a year that presented many challenges. Yet, except for a few brief sell-offs, the stock market turned in a solid performance in 2021. The S&P 500 gained 26.9% for the year. The Dow Jones Industrial Average (DJIA) gained 18.7% in 2021, while the Nasdaq Composite gained 21.4%.

Over the course of the year, investors brushed off news that could have derailed stocks in years past. A contested presidential election, historically high inflation, supply chain disruptions, forecasts calling for a correction (that never appeared) — none of these events stopped stocks from posting all-time highs. Not even the still-raging global COVID-19 pandemic, or its Delta and Omicron variants.

In fact, the S&P 500 posted 70 all-time highs in 2021, a record that's second only to 1995. The 2021 market was bifurcated with an initial surge in some high-flying growth stocks, but then many of those names fell hard, and some of the big-cap names in the S&P 500 turned in super-charged performances. Cyclically sensitive stocks strongly outpaced more economically defensive ones. Oil and other commodity prices surged. Energy was the top performer of the major sectors in 2021, up 48%, its best increase ever.

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The very robust economic recovery gave investors a big reason to remain optimistic. There has been a really strong fundamental story unfolding from a macroeconomic perspective. With the economic expansion, as well as the bull market, only being a few months old when 2021 began, the market's performance isn't so surprising - and could very well continue.

The labor market recovery has been particularly notable. Since April 2020, the US has added 18.5 million nonfarm jobs, and the number of people filing for unemployment claims has recently reached a 52-year low. Dynamics have also swung in favor of workers over their employers, which has emboldened millions of workers to quit their jobs at unprecedented rates, or demand higher wages. Upward economic mobility has long been at the heart of the "American Dream" and has returned with a vengeance.

The stock market in 2021 also benefited from a very accommodative Federal Reserve. Throughout the year, the Fed kept interest rates near zero and continued pumping billions of dollars into markets each month. This not only encouraged investors to seek out assets with higher returns, like stocks, but also contributed to higher inflation.

It was indeed inflation, and its potential impact on economic growth and the stock market, that was one of the biggest stories of 2021. The year ended with the Consumer Price Index (CPI) rising at the fastest pace since the early 1980s, meaning that it's likely the first time that many consumers and investors have dealt with this type of inflation.

Investors are keenly aware that the Fed's support will undoubtedly come to an end. The big question on Wall Street for much of 2021 was when that would ultimately happen. The Fed has indicated plans to increase the fed funds rate at least

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three times in the new year to temper inflation. This could happen as early as March, and would be the Fed's first rate hike since 2018.

As the Fed eases up its support, investors will once again focus more on whether the fundamentals that drive stock prices—the pace of economic growth and corporate earnings—can support another year of double-digit gains.

From our perspective as portfolio managers, we are focused on whether a major shift in sentiment is occurring. Particularly, whether growth stocks will finally take a back seat to more value names. As we write, a major selloff has been in play, with growth stocks in the crosshairs. The NASDAQ, which is predominately made up of high-growth tech stocks, has started the year with a significant decline. The "Santa Claus" rally, that saw tech stocks rally the last few days of 2021, has quickly reversed itself to start 2022.

This rotation out of higher valuation growth stocks began late in the third quarter of 2021, and persisted through the fourth quarter. Much of this was driven by a compression in valuation as interest rates rose, the Fed signaling a much tougher stance on its accommodative policies for 2022, and market participants' fears of higher inflation, which further impacts interest rates.

From a technical analysis perspective, we have seen the relative performance of value improve dramatically relative to growth. This is evident when comparing the relative performance of certain sectors – such as regional banks (value) versus technology software (growth) or in analyzing the Russell 1000 Value Index relative to the Russell 1000 Growth Index. While this relative outperformance began in September of 2020, it accelerated during the fourth quarter of 2021 and appears to be persistent.

Many different arguments can be made for value outperforming growth going forward, but the simplest may also be the most valid – a cyclical reversion to the mean. Growth has outperformed value over the last 10 years or so, during this unprecedented run of ultra-low interest rates. The biggest headwind to value's performance has been the Fed's Quantitative Easing and falling interest rates, but during periods of rising rates, value generally has outperformed. When rising inflation expectations are added to the mix, the signal for value outperformance is more compelling.

A few sectors have been showing a positive relative trend. Energy, Basic Materials, Transports, and some Financials, in particular, have been trending positive. These are all cyclical groups, and also have general positive exposure to reflationary trends. Inflation, incidentally, in isolation, is not a bad word. The real risk to markets is too much inflation hurting consumer confidence, or producing fear of uncontained inflation. This is not necessarily what markets seem to be pricing. If markets were worried about either of the above, defensive sectors and/or growth stocks would be leading. Instead, we are seeing cyclicals lead.

As always, it is important to consider these factors over the long term. Market dynamics, such as a major sector rotation, don't happen overnight. They produce many ups and downs and false starts. The expectations of a first interest rate cut during a tightening cycle usually creates waves, but don't often indicate a discernible trend.

Given the current backdrop, there is no better time to review your goals, revisit your future expectations and evaluate your overall asset allocation and risk tolerance. We strongly encourage you to take advantage of all the capabilities that our firm brings to bear, which will help you to live with increased financial confidence.

Please feel free to reach out to us to review your personal situation, so we can ensure that we have built your portfolio to accommodate your various needs, and address any concerns that you may have. We appreciate the opportunity to serve you, and appreciate the trust and confidence that you have placed in our firm.

Scott A. Goginsky, CFA®
Partner, Research Analyst, Portfolio Manager

Sources: Index returns – Forbes, Bloomberg; Sector performance – CNBC; Labor market, CPI – Forbes; Growth vs. value – JP Morgan

Important Tax Filing and IRA Contribution Dates

The 2021 federal income tax filing, payment and IRA contribution deadline is Monday, April 18, 2022.

2021 and 2022 Contribution Information*

	2021	2022	Age 50+
Traditional or Roth IRA	$6,000	$6,000	Additional $1,000
SIMPLE IRA	$13,500	$14,000	Additional $3,000
SEP IRA	lesser of 25% of compensation or $58,000	lesser of 25% compensation or $61,000	

*Some restrictions and limitations may apply; we recommend you review your particular situation with your tax preparer.

As long as you are still working, there is no age limit to be able to contribute to a Traditional IRA. The Secure Act, signed into law on December 20, 2019, removed the age limit in which an individual can contribute to an IRA. The top age prior to the law was 70 1/2.

How to Capitalize on Lawmakers Inability to Pass New Tax Laws

It wasn't too long ago the advisor community was scrambling to address what many intelligent advisors thought was imminent sweeping tax legislation.

I remember internal discussions with the advisor team here, evaluating ways to plan for potential increases to the capital gains tax and the potential estate tax exemption getting cut in half. The concern was justified because of a political shake up in the House of Representatives, the Senate and the White House. We were bracing for a short order, substantial change to the tax code we have grown accustomed to navigating.

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Surprisingly though, the biggest tax story to date has been what hasn't happened.

No billionaires tax, no change in the top income tax bracket, no increase in the capital gains tax rates, and no decrease to the lifetime estate tax exemption. The only changes thus far in the tax laws have gone the complete opposite direction of what everyone was expecting!

In fact, the estate tax exemption increased for 2022. With the latest increase for inflation, individuals can now gift a whopping $12.06 million without paying a dime in tax. For married couples filing a joint return, the exemption is $24.12 million.[1] This is the highest estate tax exemption amount there has ever been.

The long-term capital gains tax rate is still just 15% for married taxpayers filing a joint return, all the way up to $517,200 of taxable income in 2022.[2]

Contrary to what was anticipated just one year ago, stock market performance in addition to the lack of tax change has created arguably one of the most favorable times in history for wealthy households.

That being said, it's not time to sit back and delay taking action. It is time to accelerate action because the lack of policy change has extended what, for some, will be a once in a lifetime opportunity to build and preserve wealth.

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How Do You Take Action?

Go back to one of the most important questions in investing: What is your time frame with the money you are investing?

If there is one certain weakness the government has regarding tax legislation, it's short sightedness. It's this short sightedness that forces lawmakers to welcome tax strategies such as Roth IRA conversions. This is because Roth conversions raise tax money today that is desperately needed to fund high levels of government spending.

A Roth conversion involves moving assets from a pre-tax retirement account to an after-tax Roth IRA. You pay taxes on the assets that are moved. Once those assets are in the Roth IRA for 5 years and you reach age 59.5, however, those assets and all of the growth can be distributed tax free. Even more attractive for some, there is no required minimum distribution (RMD) obligation on Roth IRAs, for the life of the owner. Non-Spouse, non-eligible beneficiaries may be subject to RMD's, but those distributions are also tax free.

Another potential strategy involves gifting. Gifting is a great way to keep assets in the family and potentially protect them from estate taxes. With the current gift tax limit so high, people can now move more wealth than ever to the next generation, or other important people in their lives. Although the annual gift exclusion amount is only $16,000 per person per year in 2022, you can exceed that amount and still pay no taxes on that gift by filing the appropriate tax form, to correctly disclose the use of your lifetime exemption.[3]

Moreover, Roth conversions and gifting strategies are not restricted by income figures like many other tax planning strategies. For this reason, these techniques in particular pose a potential value add for a large variety of people in many different scenarios.

Remember, the goal with any good tax planning strategy is to legally pay the least amount of tax over the planning horizon. For some people, the planning horizon is a year. For some people, the planning horizon spans multiple generations or longer. It is vital to apply your specific set of priorities, facts and figures to the current tax and investing environment.

What to Do Next

Now is a great time to discuss your planning horizon with your advisor. It makes more sense than ever to get the next generation of your financial plan involved. Communicating your values and intentions with heirs is most effective when it's done early and often. You'd be surprised how important it is to children and grandchildren to uphold the values of their parents and grandparents.

But they can't do that if they're not informed. Tax rates are low relative to historical rates. We know that many significant tax rates are set to expire on December 31, 2025.[4] Careful consideration should be given to determining if it makes sense to accelerate income into these next few years. After the close of the 2025 tax year, it may be a while before we see rates like these again. We look forward to speaking with you and others you want to involve in your investing and financial planning priorities.

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[1] https://www.irs.gov/businesses/small-businesses-self-employed/estate-tax
[2] fpPathfinder/Important Numbers
[3] Instructions for IRS Form 706 Rev. Sept. 2021
[4] Tax Cuts Jobs Act of 2017

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