The *Philadelphia* Story

A Quarterly Commentary on the Economy & the Financial Markets January 2022

From: *Philadelphia* Investment Management Group

OVERVIEW

- ***The Federal Reserve Has Mapped Out the Strategy for 2022 Regarding Its Asset Purchases and Interest Rate Increases.*** *There has also been some discussion regarding a strategy to reduce the size of the Federal Reserve's portfolio of U.S. Treasury and corporate bonds.*

- ***Inflation, Inflation – One of the Main Subjects in Conversations Regarding the Economy.*** *Is it transitory or beginning to look as if there is an embedded inflation rate and thus a need for some adjustments to monetary policy?*

- ***The Dollar Will Remain the International Reserve Currency of the World as Long as Monetary and Fiscal Policy Maintain a Sound Footing.*** *It is imperative, with China, bitcoin and talk of a basket of other currencies knocking on our door, that the U.S. continue to see that the dollar remains stable and worthy of continued support from around the world.*

THE ECONOMY

At the Federal Reserve's policy meeting in December, officials agreed to wind down its bond-purchase stimulus program more quickly than previously reported amid growing concerns about trending higher inflation numbers. Markets see this action of tightening monetary controls as a signal of the Central Bank's desire to deliberately slow the economy. The rationale for these moves by the Fed is that the economy is so much stronger now than it was when the programs were put in place and that we are much closer to full employment. Our concern with the above action is that the Fed has to be very careful not to overshoot and throw the economy into a recession. The markets do not like significant change in monetary and fiscal policy as they now contemplate the changes being discussed.

The third bullet point above discussing the importance of the "dollar" cannot be over-emphasized as we move forward with the forthcoming actions regarding asset purchases and interest rates. We read about China and cryptocurrency today more than at any time in the past few years. China is determined to have its currency recognized as an international reserve currency with solid political and economic backing. Look no further than the investments the country makes around the world in exchange for such acceptance. Cryptocurrency, as well, has been introduced into the mainstream of thinking to become a currency of choice in place of or at the side of the dollar. It is imperative that the U.S. Government not lose its international global reserve currency status. The purchase of our dollar by the rest of the world provides, in large measure, the tool for the U.S. to conduct its business, both here and abroad.

In summary, our position is that the supply issue will continue to correct itself, which will take pressure off businesses that need to raise prices to compensate for their higher costs. In addition, with the stimulus money slowly winding down in the hands of the recipients, businesses will, once again, be able to attract needed employees. This, coupled with an adequate supply of materials, will put the economics of business back into its proper relationship.

FINANCIAL MARKETS

EQUITIES

In spite of difficulties in Corporate America in 2021, the equity markets shared similarities with 2020, closing near record highs. All of the major indexes had positive returns for the year, as reflected in the chart below, with the Russell 2000 index of smaller companies having the least positive year, but still ahead 14.82%. Global equities gained as well, ahead for the year at 18.5%, focusing on economic and earnings fundamentals over the worries about the COVID-19 pandemic.

	Equity Returns*				
Index	**4th Qtr**	**3rd Qtr**	**2nd Qtr**	**1st Qtr**	**2021**
S&P 500	11.03%	0.58%	8.55%	6.17%	28.71%
Dow	7.87%	-1.46%	5.08%	8.29%	20.95%
NASDAQ	8.28%	-0.38%	9.49%	2.78%	21.39%
Russell 2000	2.14%	-4.36%	4.29%	12.70%	14.82%

*Total: price change + reinvested dividends

One thing to focus on as we review the various sectors of the S&P 500 is the weight of the groups to the overall Index composition. For instance, as shown below, the Technology weight, at year end, made up 29.2% of the total, a weight that is largely due to the hefty gains last year in the underlying Technology companies. As this weight increases over the course of the year, it is prudent to trim these gains in favor of groups that have not seen such movement.

	S&P 500		
		Returns*	
Sector	**Weight**	**4th Qtr**	**2021**
• Energy	2.7%	7.97%	54.64%
• Materials	2.6%	15.20%	27.28%
• Industrials	7.8%	8.64%	21.12%
• Cons. Discretionary	12.5%	12.84%	24.43%
• Consumer Staples	5.9%	13.31%	18.63%
• Health Care	13.3%	11.17%	26.13%
• Financials	10.7%	4.57%	35.04%
• Info Technology	29.2%	16.69%	34.53%
• Communication Svcs	10.2%	-0.04%	21.57%
• Utilities	2.5%	12.93%	17.67%
• Real Estate	2.8%	17.54%	46.19%

12/31/21
*Price + income
Source: S&P Dow Jones

This year is starting off with a different footing than what ended 2021. With the economy slowing, monetary conditions tightening and inflation at its highest level for some time now, the market has been spooked. Investors suspect a repeat of previous market reactions to such news of inflation and interest rate decisions. However, the Federal Reserve is as concerned about recession as it is about inflation, and it will navigate a closely monitored course to see that its actions do not railroad the recovery presently underway in the economy.

This by no means is an easy task for the Fed. Look no further than the disruptions caused by the pandemic to understand the unfortunate conditions under which we are living. Although one can build a case for the equity markets being overvalued given the conditions of business, there remain opportunities in areas that have not been overly exploited.

FIXED INCOME

Fixed income markets had to contend with some unsettling news in 2021, primarily caused by inflationary talk and the winding down of the Fed's asset purchases. While the U.S. Treasury Inflation-Protected Securities, called the U.S. TIPS Index, returned a positive 5.7%, the U.S. Treasury bond index posted a 2.38% loss, as shown below. Investors, however, continued to pursue higher-yielding bonds, as evidenced by the high-yield bond index rising 5.36%.

In spite of difficulties in Corporate America with the demand/supply imbalance, the U.S. high-yield default rate fell below one percent in 2021. Municipal bonds continued to see robust demand in 2021 as the potential for higher income taxes helped fuel investor appetite. The Municipal Bond Index gained 1.83% for the year. Although not shown in the chart, the general theme of lower quality credits outperforming higher credit also extended to the municipal market.

Fixed Income Returns

Index	**4th Qtr**	**2021**
Corp/Govt	0.26%	-1.76%
Int. Corp/Govt	-0.53%	-1.34%
Long Corp/Govt	2.26%	-2.76%
U.S. Government	0.35%	-2.38%
- Intermediate	-0.51%	-1.65%
- Long	3.03%	-4.59%
Corporate	0.17%	-0.95%
- Intermediate	-0.57%	-0.85%
- Long	1.47%	-1.13%
- **Quality**		
- AAA	0.97%	-2.38%
- AA	0.43%	-1.44%
- A	0.13%	-1.77%
- BBB	0.14%	-0.19%
Municipal	0.84%	1.83%
- Intermediate	0.17%	0.48%
- Long	1.33%	2.76%

Source: ICE BofA

Declines in the unemployment rate in December, coupled with higher inflation, are likely to keep the Fed on track to lift interest rates. In addition, Fed officials approved plans to more quickly scale back, or taper, their bond-buying program, ending by March instead of June. There has also been continued discussion about how soon and how fast to shrink their asset portfolio once interest rates have been raised.

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In conclusion, while 2021 ended with record-setting equity returns and stable bond yields, 2022 started in an opposite fashion, with a market worried about inflation and rising interest rates. On a positive note, the risk of over-tightening is front and center in the minds of the Federal Reserve and the Administration. Yes, we can expect some tightening in sympathy with the higher inflation numbers we are seeing; however, economic growth continuing into 2022 is the Fed's number one aim with some tightening of money supply while the demand/supply equation comes back into balance.

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