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Bangor Wealth Management

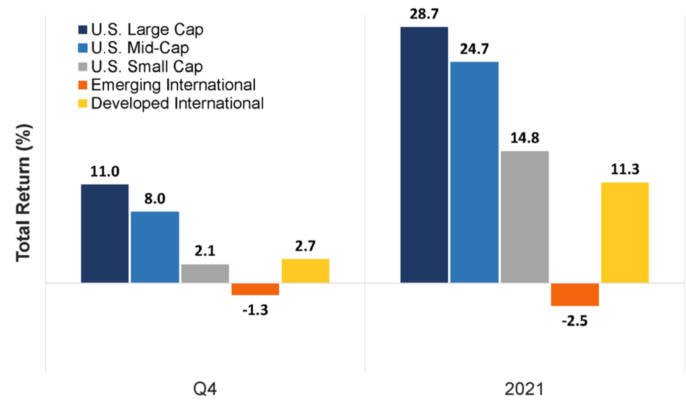
Key Points

- Risk assets had another excellent year
- Interest rates are up across the entire yield curve, leaving fixed income investors wanting
- The Federal Reserve turns hawkish as inflation proves more than "transitory"
- Economic growth is relatively strong as COVID continues to challenge parts of the economy

2021: By the Numbers

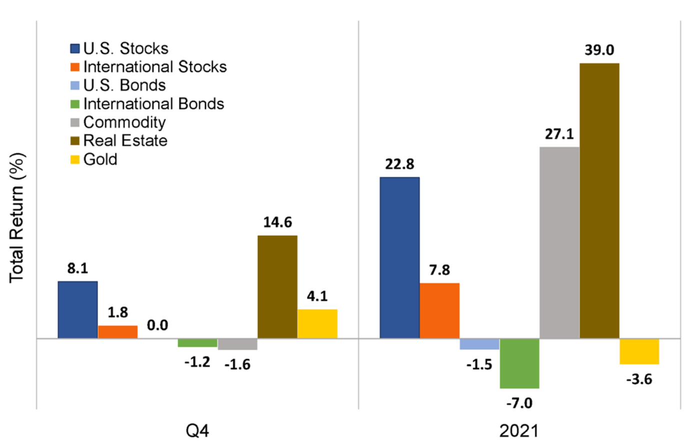
It may be hard for the new year to live up to its predecessor, as 2021 was another very strong year for most risk assets. When considering broad asset classes, real estate (REIT) led the way with a stellar 39% return, followed by commodities and US stocks, returning 27% and 23%, respectively. U.S. and Developed International Bonds performed poorly in the face of higher interest rates (Fig.1). Within equity asset classes, US Large Cap once again dominated (Fig. 2). The S&P 500 posted its third consecutive year of double digit returns, up 28.7% including dividends, as well as making 70 new record highs in the process. Remarkably, all 11 S&P industrial sectors posted positive returns for the first time since 1995. (Fig. 3)

Fig 2. Led by large cap stocks, the U.S. continued to lead global equity markets



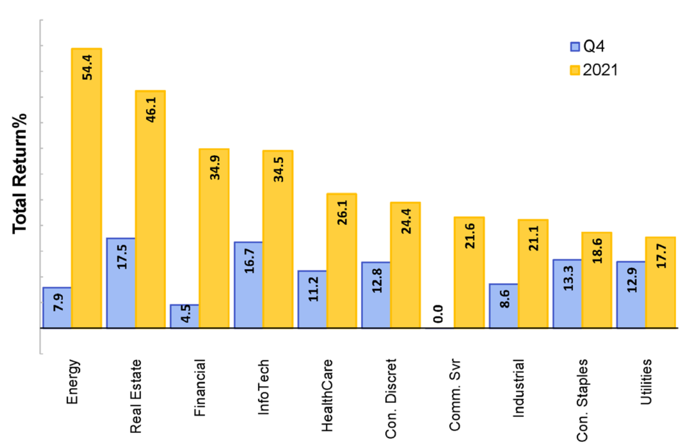
Data Sources: Bloomberg Financial LP, Bangor Savings Bank

Fig 1. U.S. stocks, real estate and commodities outshone all other major assets for the quarter and full year



Data Sources: Bloomberg Financial LP, Bangor Savings Bank

Fig 3. All 11 S&P sectors delivered double digit returns in 2021. Economically sensitive sectors dominated.



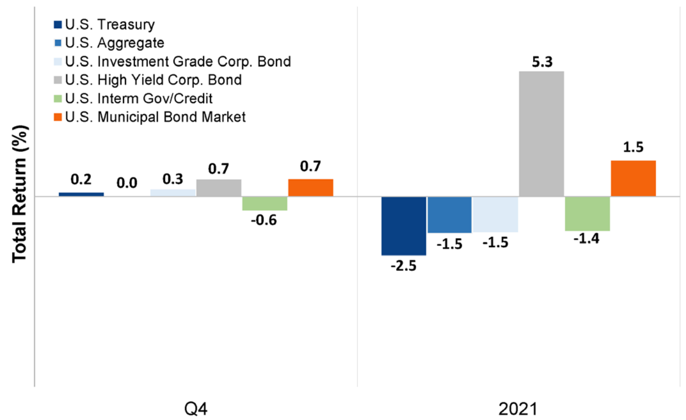
Data Sources: Bloomberg Financial LP, Bangor Savings Bank

Emerging markets were the only major equity asset class to post a negative return for the year. China, which comprises 32% of the MSCI Emerging Market Index, was the largest detractor in the index, down 22% for the year.

One of the chief drivers of US equity returns in 2021 was extraordinary earnings growth. As we have written here before, analysts consistently undershot the mark in predicting results. According to FactSet, in December 2020 calendar year 2021 growth estimates for the S&P 500 were 22%. Fast forward to December 2021 and the current estimate is for growth of 45%. Fourth quarter 2021 earnings have yet to be announced, but if actual results for the calendar year come in at 45% it will mark the highest level of earnings growth since FactSet started recording the data in 2008. This strong growth can be attributed to both an easy comparison to a weak 2020 and strong end demand.

In rather sharp contrast to equities, fixed income investors had a difficult year. After interest rates plunged early in 2020, they have moved higher since. Long rates peaked in the first quarter of 2021, and shorter term rates, as measured by the U.S. 2yr Treasury, climbed steadily throughout the second half of the year. As a result the Barclays Aggregate Bond Index declined 1.5% for the full year. Consistent with other risk assets, lower rated credit (high yield) returned 5.3%, one of the few bright spots in fixed income. Another relatively strong category was municipal bonds, driven by lower supply and anticipation of higher tax rates from Washington (Fig. 4).

Fig 4. Rising inflation expectations and hawkish monetary policy drift have negatively impacted most fixed income markets



Data Sources: Bloomberg Financial LP, Bangor Savings Bank

The Economy

Economic strength has, like corporate profits, been better than expected. For the full year, GDP is expected to grow 5.5%, which is 1.5% higher than expected a year ago. The unemployment rate is near pre-pandemic levels at 4.2, although the labor participation rate, which measures what percent of the population is actually employed or seeking employment, has only recovered about half of what was lost in early 2020.

The strength in demand for goods and the effects on labor are both symptoms of the ongoing pandemic. The pandemic drove certain consumer behaviors and funneled demand out of some areas (e.g. restaurants) and into others (groceries). A lack of workers has also impacted supply both in terms of production and transportation. This unfortunate combination has resulted in higher prices for many goods.

The Federal Reserve initially expected the rising prices to be short-lived, but then changed their tune as both CPI and core inflation have remained elevated. As recently as November, headline inflation was 6.8%, its highest level in almost four decades. And still the number of job openings exceeds the number of those seeking work. So while the Federal Reserve may intend to reduce monetary stimulus slowly to head off inflation, higher prices are not entirely a monetary phenomenon. Given the onset of the Omicron variant and the large spike in recent cases, some of these supply chain issues are likely to take further time to resolve.

The Pause that Refreshes?

As we look forward to 2022, it seems appropriate to lower our expectations for capital market returns. Many factors that accelerated growth, like an extraordinarily accommodative Federal Reserve and strong fiscal stimulus, are now gone or in the process of being reduced. Corporate profits, while still reasonably strong, likely won't have the same degree of positive surprise on their side. Fixed income may have seen the brunt of the negative impact of higher interest rates, but we do expect some continued drift higher both on the short and long ends of the curve.

As always, if you have questions regarding any of these points or how your portfolio may be impacted, don't hesitate to reach out. We look forward to working with you in 2022.

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