

Stapp Financial Investment Letter

Stapp Wealth Management, PLLC

Fourth Quarter 2021

Market Recap

It's been another remarkable year for the S&P 500 Index, with the index of large-cap U.S. stocks returning a stunning 28.7%. It meaningfully outperformed U.S. small-cap stocks (the Russell 2000 Index was up 14.8%), developed international stocks (MSCI EAFE Index, up 11.3%), and emerging-market (EM) stocks (MSCI EM Index, down 2.5%) for the year. Much of this outperformance occurred in the fourth quarter, with the S&P 500 gaining 11.0%, compared to 2.1%, 2.7%, and -1.3% for small caps, developed international stocks, and EM stocks, respectively.

A strong dollar, the renewed surge in COVID-19 infections late in the year (particularly in Europe and emerging markets), and China's policy-induced economic slowdown and stock market decline drove the disparity of returns. The MSCI China Index sank 21.7% for the year and lost 6.1% in the fourth quarter. Chinese stocks comprise roughly 35% of the MSCI EM Index. The MSCI EM ex-China Index gained 10.0% for the year.

Turning to the bond markets, the core bond index (Bloomberg US Aggregate Bond Index) lost 1.5% for the year, as interest rates rose moderately. The benchmark 10-year Treasury bond yield ended the year at 1.51%, compared to a 0.92% yield at the end of 2020. Given the very sharp rise in inflation, most pundits would not likely have predicted such a mild increase in bond yields.

Finally, credit markets fared much better than core bonds in 2021. The U.S. high-yield bond index returned 5.4% (ICE BofA ML High Yield Cash Pay Index) and the floating-rate loan index gained 5.2% (S&P/LSTA Leveraged Loan Index). These returns were consistent with our expectations for a recovering and growing economy.

Investment Outlook

Our base-case macro and market scenario is cautiously optimistic: that the pandemic recedes (but doesn't disappear), the global economy slows but still grows above trend, corporate earnings growth slows but is still solid, the U.S. rate of inflation remains elevated but is falling, and U.S. interest rates rise moderately.

That would be a positive scenario for the economy and global equity and credit markets, although not for the core bond market. But even in the best case, it likely won't be a smooth journey: The pandemic remains uncontained, domestic and global political and social tensions are elevated, the risks of an economic policy mistake have risen, and any number of other bumps in the road (or worse) may occur. And were we to see a sharply inflationary environment that is well above our, and current consensus expectations, it would undoubtedly be damaging for both stocks and bonds, as interest rates rise and equity market valuations fall.

All these considerations (and more) factor into our analysis and current tactical portfolio positioning. We would benefit nicely from our highest-conviction tactical shifts in our base case, but our portfolios are also strategically balanced and well-diversified across a range of global asset classes, alternative

strategies, and risk-factor exposures. This should enable them to be resilient should a risk scenario or shock outside our base case occur.

Overall, our portfolios are positioned with (1) a small overweight to global equities, through our tactical overweight to EM stocks; (2) a large overweight to flexible, actively managed fixed-income funds and floating-rate loan funds; (3) positions in lower-risk and diversifying alternative strategies; and (4) an underweight to core bonds (interest rate/duration risk).

Within our global equity allocation, we continue to maintain an allocation with a slight overweight to growth. We are also regularly adjusting and shifting our preferences for certain sectors in the US market on a monthly basis and acting when we see opportunities. We do see potential for value and cyclical stocks to rebound (again) as COVID-19 recedes and interest rates rise. And value stocks in aggregate still look very cheap versus growth. But we also want to maintain exposure to high-quality, innovative growth companies with strong competitive advantages that are priced at not-unreasonable valuations. Our current philosophy in this space is to rent value, but own growth.

A noteworthy point on our tactical overweight to EM stocks is that we are actively evaluating the relative opportunity between EM and European equities. This is somewhat of a moving target as relative valuations shift, but if five-year base-case returns for European equities become sufficiently attractive, their lesser exposure to some of the risks faced by EM could lead us to shift a portion of the overweight from EM to European stocks. Evaluation of relative opportunities is a regular part of our ongoing process, but in this case, we expect to reach a conclusion early in the year.

Our fixed-income positioning reflects the poor return outlook for the core bond index: The index is starting from a low sub-2% yield and interest rates are likely to rise over the coming quarters, at least until a recession hits. Our active, flexible fixed-income managers have a strong likelihood, in our view, of outperforming the index without taking imprudent risks. But we still maintain a meaningful core bond allocation in our more conservative balanced portfolios as ballast in the event of a recessionary scenario, which would hurt flexible, credit-oriented bond funds as well as stocks.

Finally, our allocations to marketable alternatives are largely a substitute for some fixed-income exposure. Again, we believe these “alt” positions offer better return prospects plus beneficial diversification across a range of scenarios beyond a traditional recession where core bonds shine.

Closing Thoughts

The last two years have been extraordinary in many respects. Amidst the COVID-19 pandemic and all the chaos it has wrought, there have been many reminders that markets commonly defy consensus predictions and confound investors in the short term. In the face of a deep drop in economic activity early in the pandemic, markets rebounded and have racked up remarkable gains since. More recently, as supply chain and labor market disruptions have been among the contributors to a spike in inflation, increases in bond yields have been surprisingly mild. Of course, surprises that defy prediction happen in both directions, and this is why we maintain broad diversification and focus squarely on the long term, which can be analyzed with much higher confidence—even while we work hard day in and day out to understand how the never-ending stream of new developments will impact the portfolios we manage.

As always, we thank you for your trust and welcome questions you may have.

