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TRANSCRIPT: Q4 2021 Market Update

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Hello everyone. This is Steve Elwell, the Chief Investment Officer at Level Financial Advisors, and this is your fourth quarter 2021 market update. The fourth quarter was a good quarter for stocks. Stocks rebounded, specifically in the U.S. They had a strong quarter as they rebounded from the decline that took place in the second half of September that sort of wiped away much of the third quarter's returns. The market bounced back nicely in the fourth quarter.

The U.S. stock market was up about 9.28%, international developed stocks were up less, more like 3%, and emerging markets were actually slightly down for the quarter as there was various news out of different parts of emerging market economies about tech regulatory crackdowns and some real estate issues regarding a couple of big firms that maybe had taken on too much debt. The global real estate market itself though actually did the best when you look at publicly traded REITs throughout the globe. It did the best here in the fourth quarter, earning a little more than 12% for the quarter.

The U.S. bond market and global bond market was essentially flat for the quarter, kind of a lot of information and a lot of things happening here in the fourth quarter as Congress was looking at trying to push through several different bills and interest rates dealing with the news of what might be a fourth wave of COVID coming with the Omicron variant. So a lot of moving pieces as to what's driving different segments of stock and bond market returns, but the year essentially ending at all time highs, and for many investors and clients of ours, we've heard things around the thought process of if stocks are at all time highs, is that really a good time to invest if I have extra cash? Or even if I don't have extra cash, do I think at maybe some type of pullback is going to happen soon because we've hit an all time high or we've hit multiple all time highs throughout? We've had a ton of all time highs throughout 2021, the calendar year.

And so the argument kind of is if stock markets are at an all time high, that's got to be a bad time to invest, right? And so one thing we want to highlight is as we hear that is really the evidence throughout history of the stock market, the S&P 500 specifically, doesn't really support that argument, that if the stock market is at an all time high then it's a bad time to invest. And so for instance, we're pulling up this Exhibit 1 here, which is some research done by our friends over at DFA, and they are showing a couple of things, specifically the average annualized return for the S&P 500 Index after new market highs, all time highs, and also the average return after a 20% market decline.

So traditionally people would think oh well, the whole strategy of investing right is buy low and sell high, and so when you think about that type of idea, if the market is at an all time high, then clearly you're not buying low or you don't feel like you are buying low. How could you? Prices have never been higher than what they are at the moment. And so as the flip side of that, then the argument must be well, after a 20% market decline, the future returns if you're able to buy at that price must be higher than what future returns would have been if you bought at a new market high.

And so this chart does a good job of showing that on average, over the history of the S&P 500, the returns one year later after a new market high was hit, the average annualized return one year later after that's happened is 13.9%, and the average annualized return if you bought after a 20% market decline was 11.6%, actually lower than what it would've been if you had bought on average on a new market high. When that goes out to three years, it's 10.5% percent average annualized return after a new market high and 9.9% after a 20% market decline. So that's pretty close, that's almost

equal. And after five years, the difference is virtually indistinguishable, 9.9% after a new market high and 9.6% after a 20% market decline.

So what the evidence tells us when you compare buying during a market downturn, which sometimes for people is hard to do just simply because stock prices are going down and that's scary, and the idea of taking cash or money from bonds and going to buy stocks after stocks have just gone down a lot feels uncomfortable. But even if you ended up doing that, the average forward looking return based on the evidence is really no different after five years than what it would be if you had bought at all time highs.

And that might feel a little counterintuitive. I mean, realistically, that at first blush sounds kind of counterintuitive, but I would add that remember that if stocks have hit all time highs, there's probably a reason. Something good is likely happening. And so even if we look at 2021, and past quarter's commentary, we've showed the charts that have sort of highlighted this, I'm not going to show them again because they're going to continue to say the same thing, but in 2021 profit growth for the S&P 500 has been like 26%. It's been outrageous. It's been fantastic.

So we were originally making the argument that some people were saying, how is it possible that stocks are at an all time high? Well, that's a pretty good reason, profits are 26% higher and that's quite a bit higher than what the market was expecting when the year started. So that obviously is good news, but then when you think of it in terms of well, what is happening from that profit perspective and publicly traded stocks perspective going forward, or at any other previous all time high period, and there's a whole bunch of other periods that would have good economic news, good job market news, supportive federal reserve bank policy, which we're still getting today, right?

Interest rates are still effectively zero, although that might be changing and we're going to talk about that a little later here. But in essence though, if you're talking about low interest rates, low unemployment, wage growth, lots of job openings, record high corporate profits, of course, stocks should be at an all time high. I mean, what's not to like when it comes to an investment perspective of all of that. Now I realize that there's a whole bunch of other things that are going on economically, COVID wise, health wise, politically that doesn't make it feel like a Goldilocks scenario, but if you're just focusing on the investment piece, the investment piece looks very good.

So the old classic old statement, or saying from our friend Warren Buffet would be the best time to invest was several years ago, and the second best time to invest is now. And I don't really think he was ever saying that in the moment, that particular moment when he said it, things look good. I think what he was ultimately saying is when you're talking about investing, when you're talking about compound interest, the earlier you get started, the better your chances of earning money, having that money grow, and have it grow a lot.

And so when you're thinking about okay, if I have excess cash that I'm thinking about investing, should I wait for some type of pull back? The evidence is not in favor of doing that. The evidence is in favor, and this is what Warren Buffet was saying in essence, the evidence suggests that the best time to invest is when you have the money. So we wanted to touch a little bit on that because we've heard some various things on that front and just thought it made sense to kind of cover what history tells us about what has happened other times when stock market has hit an all time high.

One other topic that we want to address really in this quarterly commentary is probably one that you have seen yourself when you go to the gas station or the grocery store, you go to pay for a home renovation or any type of project, or you

try to go buy a used car, and that topic is inflation. Inflation has been much higher this year in 2021 than what it has been in past years, or the past decade, or even longer multiple decades. Inflation is ... The headline inflation in November of 2021 was 6.9%, core inflation was 5%.

Now traditionally we had over the last decade been dealing with inflation in the range of 1.5% to 3%, most of the time around two-ish percent for inflation, so to have that be as high as 6.9% in this most current reading is obviously much higher than what it had been before. And so when we look at that, there are a few things to think about. The first and most obvious question from an investment perspective is well, what does that mean for my portfolio? And there's really two aspects of that. The first of which is well, what does the evidence say about what type of investments do well during an inflationary period? And what the evidence would tell us is that generally things like real estate companies, small stocks, and value stocks would be good categories to invest in during inflationary periods, which of course, we own slivers of all of those as part of our diverse portfolios.

The second side of that concern when you're talking about inflation from an investment perspective is well, what does that mean for my bonds? And that's a great question because of course, if the interest rate you're receiving on your bond is 1% or 2% or 3% and inflation is 6%, in real terms your returns are negative and that's obviously not what investors are trying to do when they put their money to work. They're trying to have their money grow, not only grow to keep up with inflation, but to grow ahead of inflation.

Now bonds serve different purposes as well, they have other benefits as well, particularly when you're retired and living off of your portfolio because they can be used to buy time and help cushion the blow when the stock market declines and you need cash to live off the portfolio. So that's an important benefit. But when I think about inflation and I think about bonds, I really think about two major things. Number one, we need to have some exposure to a unique government bond called a treasury inflation protected bond, which we do have exposure to and has been basically the best performing bond category that we use for 2021. In fact, if I try to look at what returns were for 2021 for our inflation protected bond holdings, they were pretty good about 5%, 5.5% for the year, which is knowing that inflation was hot, that year was the best bond category to keep up with that inflation.

The other aspect is not just the effect of inflation on your interest earned from the bond but what might happen to the price of the bond, the value of the bond or the bond fund if the federal reserve decides to turn their attention to dealing with the inflation. Because remember, they have a dual mandate. They're required to focus on two things, keeping unemployment low. Well, that mission is probably accomplished at this point. Unemployment is back down to what it was pre-pandemic. There are more job openings than basically ever. So if you're someone looking for work, there's lots of work to be found. And not only that, wages are increasing at a faster rate than they have in the most recent years. So that's good news for workers as well.

But if the federal reserve then decides to turn to their second mandate, which is to keep inflation at a moderate level, which generally they're targeting about 2% to do that with a ... They're failing at that one, right? It's pretty obvious that that one is not in line with where they want it to be. So if they feel good about the unemployment numbers and that the labor market is at full employment, what they would call full employment, then they may shift their attention, and they've already indicated that they're very likely to do this in 2022, shift their attention to dealing with inflation. And they really have one main tool to do that, and that's raising interest rates.

Now they're smart, they know what history has told us, they know what past federal reserve board governors have done when it comes to dealing with inflation, particularly from the eighties, which is the most, I suppose, similar scenario than what we're dealing with right now. And they're talking about now potentially three to four interest rate increases in 2022, when initially earlier in 2021, they were saying that they probably won't even raise rates until 2023, so that's obviously a pretty big shift to go from no rate increases in 2022 to three or four. And so their attitude and view towards inflation has changed in that initially they thought it was maybe just what they were calling transitory, so momentary inflation as we sort of work our way through the pandemic with COVID and supply chain issues that we had to deal with from that. And now they're more of an attitude that this inflation is a little stickier, a little longer lasting than what we thought, and so now we're going to tackle it, or we're going to try and sort of stomp out the fire a little bit.

So when they ... This goes back to sort of the original piece I was talking about with bonds, when they do that, when they start to raise interest rates, generally as interest rates go up, bond values or bond fund values go down. Now how much they go down depends on what type of bond it is and how long the maturity or duration, if you want to be technical, is of that bond or bond fund. So I'll give you an example. If interest rates go up and you have a really long term bond, like a 30 year us treasury bond, then that's going to be ... You're going to notice the decline, it's going to be pretty sizable as they start to raise interest rates. If you have a really short term bond, that's going to mature relatively soon, like three months, six months or one year away, you may still notice a slight decline in the value of the bond or bond fund as interest rates go up.

But because you're getting your money back so soon as the investor, when you get the cash, when the bond is redeemed, then you'll ultimately be able to reinvest at the new higher interest rate. So in essence, interest rate increases for term bonds results in a very temporary slight decline, and then ultimately end up becoming good news because as that money is reinvested you start to earn higher interest. Longer term bond holders probably should be a little more concerned as interest rates start to increase.

Now as a reminder, from an investment perspective, most of the bond holdings that we use either have automatic inflation protection like these treasury inflation protected bonds I mentioned earlier that have done really well, or they're very short term in nature. And so from an interest rate standpoint, if they start to increase, then our level of concern about that is pretty minimal given the way that our portfolios are positioned and also knowing that as interest rates start to increase, we expect to have that start to mean over the next one, two, three years that the interest we collect from those short term bonds starts to go up, which helps make up for any very small, slight temporary decline the value of the bonds have as those interest rate increases are announced.

Now generally, the federal reserve would move at a 0.25% interest rate increase at a time. That doesn't mean that's the pace they'll do for 2021, but that's the pace I expect them to do for 2021. So ultimately we'll see here in the spring at their next meeting what they decide to do and how quickly they decide to move, but it is likely to be something you hear a lot about in 2022. So as I kind of take one deeper stab at that particular topic, from an investment perspective, and this kind of circles back to point, number one about investing cash when markets are at all time highs, keep in mind that the interest rate that was currently being earned on the U.S. 10 year treasury bond at the end of 2021, December 31st, that interest rate was about 1.5%. If inflation was around 5% or so 6%, then in real terms, you're losing 3% or 4% on that money, on that investment.

And so obviously, from an investment standpoint and a real return standpoint when you factor in inflation, that is not a great return. So investors from their viewpoint, now that doesn't mean inflation is going to continue at that pace and it

doesn't mean that yields on the 10 year bond will stay that low. In fact, I would probably expect them to go up as they start to raise interest rates, but I think that goes back to one of our points that if you have cash that's sitting in the bank earning nothing, which it probably is because interest rates are zero, and inflation is 4% or 5% or 6%, then that money that is in the bank, that is slowly starting to erode the value of that. Inflation is eating away at the value of that. And that was true before too when inflation was 2%, but if inflation was 2% and you're earning nothing, then your cash in real terms is going down in value by 2%. If inflation is 6%, then it's eroding quite a bit faster, three times faster.

So I think that's just one thing that is noteworthy as we look at what interest rates are, what inflation is, and what might end up happening from the federal reserve standpoint about how to deal with that particular problem. Because from an investment standpoint, it's really, I don't want to call it a conundrum, but it's certainly something to give some thought to about what's happening. Now on the flip side, if you're someone who has a mortgage locked in at 3% or a home equity line of credit locked in at 3% or a car loan locked in at 1% or 2% or 3%, and inflation is 4% or 5% or 6%, I don't want to say that's great news but it's certainly not bad news. If your wages are increasing at that rate or if your investments have had a good year and you're paying very low interest on your debt, then generally that inflation aspect is actually helping from a debt standpoint.

So it's not all bad news and things like that. I think there's multiple different ways that you can look at it. And there's just really ... It's a moment where the average person should just be giving some thought about how is this affecting me and is there anything I could do differently to make smart decisions and help protect myself from the effect of this? So obviously, if that's a conversation that you want to have with our team and your advisor, then obviously reach out to us about hey, here's what I'm concerned about or what I want to think about when it comes to inflation or investing when markets are at an all time high.

So beyond that, a couple of other reminders while I have everyone, we're getting into tax season here. So 1099s, some of the 1099Rs for traditional IRAs or Roth IRAs have started to trickle out. We expect all 1099s be issued by the middle of February. And then also, even after that though, keep in mind that often there are corrected 1099s, particularly for non retirement accounts, so keep an eye out for any mailings or email or that you get from Schwab or from us that might mention that your 1099s are ready or that your 1099s have been corrected and you need to get the newest version of that.

And then a final reminder that for anyone looking to make a traditional IRA or Roth IRA contribution, you can still do that for tax year 2021. The deadline is April 15th, so if that's something you are interested in, please contact us and give us a heads up so we can help you get that done well before what the deadline is to make sure that it can count for 2021. And with that, thank you everyone for joining for this fourth quarter 2021 market commentary, and I look forward to talking to you next quarter.