INVESTMENT OUTLOOK

A PEAPACK PRIVATE WEALTH MANAGEMENT PUBLICATION

FOURTH QUARTER 2021: WHEN TINA MET GOLDILOCKS

Fairy tales can come true
It can happen to you…
-Johnny Richards, Young at Heart

We read fairy tales to children to teach them lessons, to learn how to handle problems, and to build resiliency. Fairy tales are populated with characters who sometimes act bizarrely or irrationally (locking away a child in a tower), ignore sensible cautions (walking alone in the woods), or encounter challenging situations (an evil stepmother). Often, the young protagonist overcomes a difficult or dangerous situation, resulting in a satisfying and tidy resolution.

Wall Street, for its part, has a child-like belief in its favorite narratives and a rotating cast of well-loved characters. For years now, we have embraced Tina, an acronym for **T**here **I**s **N**o **A**lternative, to explain that in a near zero-interest rate environment, equities are the only viable investment in public securities markets. Tina has been a domineering figure over the past dozen years, ever since the Fed dropped interest rates in response to the global financial crisis.

More recently, Goldilocks has been contemplating coming out of retirement. Goldilocks, the Wall Street version, thrives when the economy is not too hot and not too cold, and a delicate equilibrium between stimulus and tightening can be maintained. Like all stars who reinvent themselves, Goldilocks may appear differently than she has in the past.

It's important to remember that fairy tales are not necessarily meant to be believed—at least, not literally. But they convey meaning symbolically, and therein lies their power. And who doesn't want to believe in happily ever after?

BEANSTALKS, UNLIKE TREES, GROW TO THE SKY

There are giants in the sky!
There are big, tall, terrible, awesome, scary, wonderful
Giants in the sky
-Stephen Sondheim, Into The Woods

If you knew that 2021 would end with a record number of COVID cases, and that US inflation would be more elevated than it has been in 39 years, would you predict a robust US stock market recording 70 record high closes? No? Well, let's face it, none of us would have traded a cow for some magic beans, either—but it worked out pretty well for Jack.

Markets, like Jack, set worries aside, and climbed, almost to heaven, in the fourth quarter. US large cap stocks generated double digit returns, and small cap stocks and international developed markets generated healthy returns. Real estate was the stand-out, up 16%. Only emerging markets and commodities turned in slightly negative results. Bonds and cash marked time.

Asset Class	Index	4th Quarter Results	Full Year Results
US Large Cap Stocks	S&P 500 Total Return	11.0%	28.7%
US Small Cap Stocks	Russell 2000	2.1%	14.8%
International Developed Markets Stocks	MSCI EAFE	2.7%	11.3%
Emerging Markets Stocks	MSCI EM	-1.3%	-2.5%
Real Estate Securities	MSCI US Real Estate	16.3%	43.1%
Commodities	Bloomberg Commodities Futures	-0.02%	27.1%
Bonds	Bloomberg Barclays US Aggregate	0.01%	-1.5%
Cash	FTSE 3-month UST Bill	0.1%	0.3%

SOURCES: THE WALL STREET JOURNAL, STANDARDANDPOORS.COM, FTSE, MSCI, BLOOMBERG

For the full year, US large cap stocks turned in a sky-scraping 29%. Returns on small cap stocks and international developed markets were robust, too, and real estate securities posted stellar gains. Commodities performed well, participating in the reflation trade. Bonds, like Cinderella, were not invited to the ball, suffering from rising interest rates. Cash continued to generate no return.

ATOP THE BEANSTALK: PRINCELY SUMS

And you scramble down
And you look below
And the world you know
Begins to grow
-Stephen Sondheim, Into The Woods

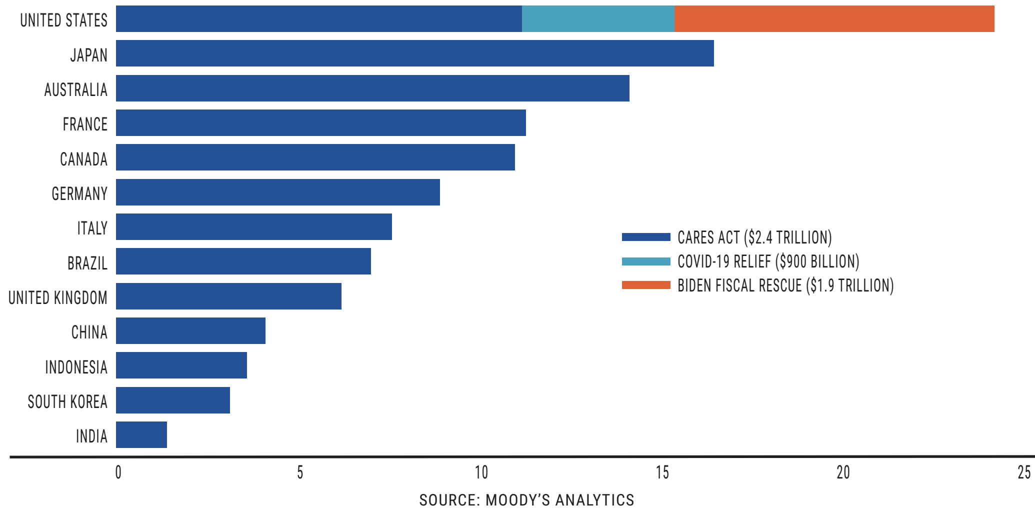
Strong markets no doubt reflected, to a substantial degree, the recovery in the US economy from the brief but sharp pandemic-induced recession in early 2020. Although GDP growth slowed to 2.3% in the third quarter, because of the Delta variant, for the full year the US economy rebounded sharply.

US Real GDP Growth

SOURCE: MORNINGSTAR

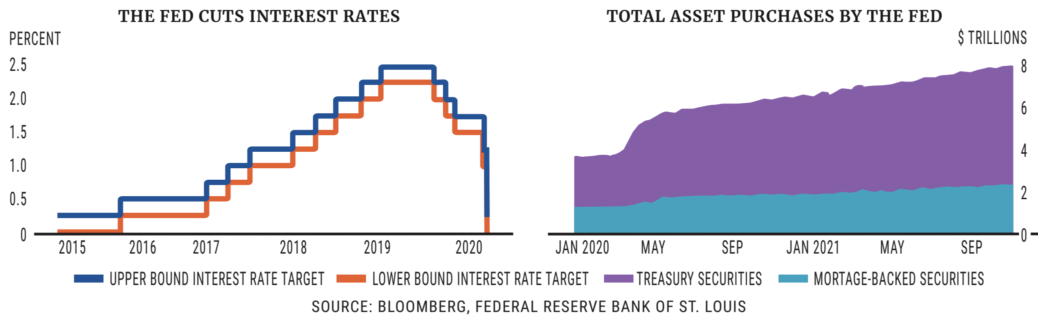
While growth in the economy next year cannot sustain 2021's furious pace, it is likely to come in substantially faster than pre-pandemic levels. Morningstar is calling for 4% GDP growth, fairly representative of most economists' forecasts.

The economic recovery owes much to the all-out efforts by the US government to stimulate the economy. The US government wielded a larger-than-life-sized checkbook, spinning gold out of the straw of borrowed funds.



Congress's fiscal response to the pandemic was dramatically greater than other nations' responses, and contributed significantly to the more robust US economic recovery. US fiscal stimulus measures were both more rapid and of significantly greater magnitude than measures effected in the 2008 recession. Other developed nations provided about half the fiscal support as the US, while emerging economies—with more limited resources—provided fiscal support that averaged only about one third of the US response.

Not to be outdone, the Fed also rode to the economy's rescue with emergency stimulus measures that dwarfed its prior response to the global financial crisis. It cut interest rates to near zero, and doubled the size of its balance sheet, purchasing $4 trillion of Treasury and mortgage bonds. The Fed is clearly richer than any fairy tale prince dreamed of being.



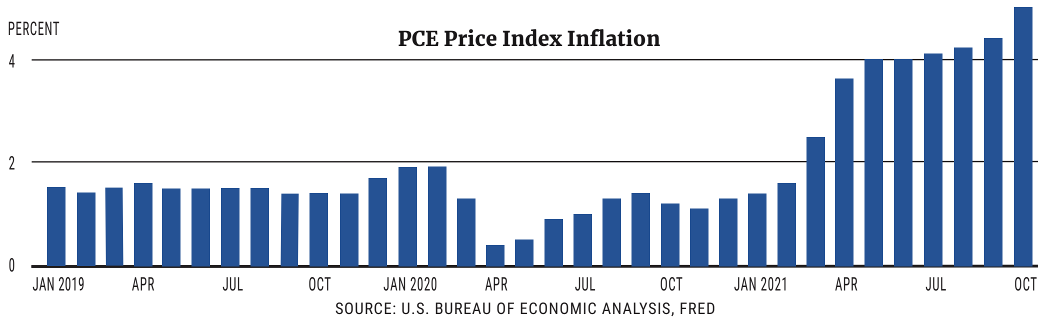
With so much stimulus, it's little wonder that the economy has experienced such a rapid and substantial recovery. The predominant effect of such 'all-of-government' stimulus efforts has been to raise demand. Consumers, flush with cash from substantial government support payments, initially reduced debt and added to their savings. And they refinanced their loans to take advantage of lower rates. These moves have positioned them to purchase all manner of goods to improve their homes, replenish their wardrobes, and drive newer cars. It's also driven the demand for both real assets (such as housing) and financial assets (such as stocks).

The widespread availability of COVID vaccines, of course, has also been critical to the economic turnaround—notwithstanding the succession of variants that has periodically slowed the world's progress in moving through and beyond the pandemic.

INFLATION: A NIGHTMARISH TALE?

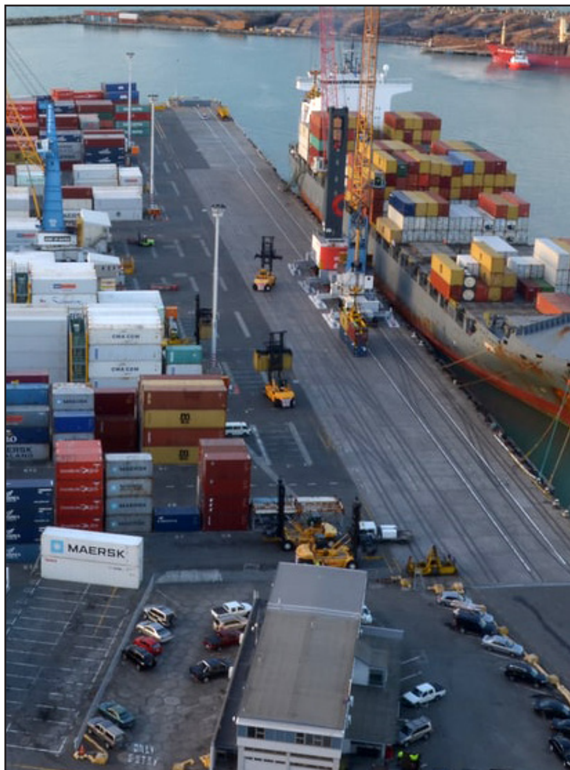
Inflation is always and everywhere a monetary phenomenon in the sense that it is and can be produced only by a more rapid increase in the quantity of money than in output.
-Milton Friedman

The enormous magnitude of government support for the economy has brought some undesirable unintended consequences. Perhaps the most prominent is a spike in inflation that has jumped higher and lasted longer than the Fed and other authorities anticipated.



The Fed interprets its price stability mandate as inflation averaging 2% over time, utilizing its preferred measure of Personal Consumption Expenditures. With readings well in excess of 4% for a number of months now, inflation is clearly running at an unacceptably hot level.

There has been considerable focus on supply challenges to explain the inflation surge. These include aggressive factory shutdowns in Asia to contain virus spread, shipping and transportation challenges, and shortages of computer chips and other critical inputs, all of which have contributed to higher prices.



It may be, however, that the greater influence on inflation is tremendous demand that stimulus measures have fostered. It is unsurprising that, following lockdowns, consumers would act on pent-up demand for a range of goods and services. But the aggregate effect of multiple rounds of stimulus checks deposited in consumers' bank accounts and ultra-low borrowing costs has been to stoke that demand to record levels—exacerbating shortages and driving prices higher. This effect is readily seen in prices for homes, used automobiles, breakfast cereal, gasoline and so on, and in low inventory levels for appliances, new cars, furniture, and so on.

Chair Jerome Powell, the Pied Piper of the Fed, has—perhaps belatedly—recognized the problem and is leading the Fed to taper its bond purchasing activity. Further, the Fed is expected to raise interest rates up to four times in 2022. It remains to be seen if this trail of breadcrumbs will in fact lead us back to price stability—or will, as in *Hansel and Gretel*, be consumed by birds and leave us lost in the inflationary woods.

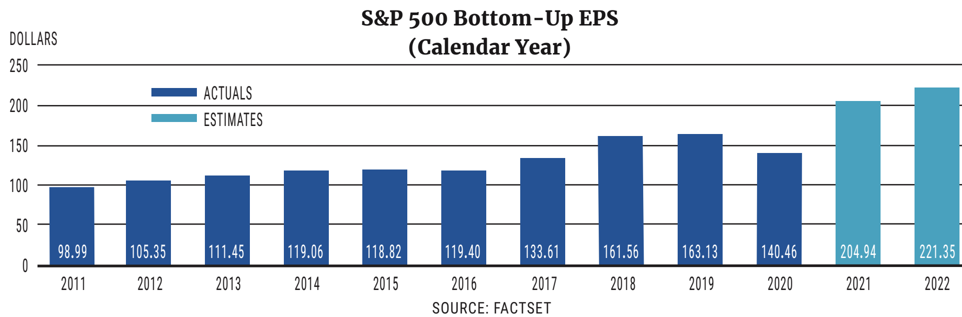
Shipping Constraints Have Contributed to Supply Shortages.

STOCK MARKET APPRECIATION: THE MIRACLE OF OPERATING LEVERAGE

This was just a moment in the woods.
Our moment, shimmering and lovely and sad.
Leave the moment, just be glad
For the moment that we had.
Every moment is of moment
When you're in the woods…
-Stephen Sondheim, Into The Woods

US large cap stock price appreciation of 29% in 2021 was fueled by strong operating fundamentals. Refinitiv reports that in the third quarter, for the S&P 500, revenue grew by 17%, and profits grew by almost 43%. Over 81% of companies reported earnings above analyst estimates. The biggest gains were recorded in the energy and materials sectors.

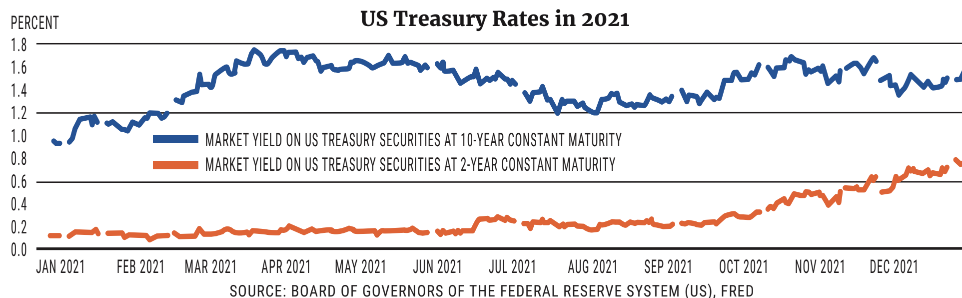
Granted, these magical figures represent gains over low prior-year results. Such a moment will not occur again. That said, these results are also impressive versus comparable pre-pandemic levels.



Top line revenue growth is a direct result of increased demand, further supported by higher prices as companies pass along increased costs. Even more robust bottom-line growth is a function of lean staffing levels.

Looking ahead, earnings for the just-completed fourth quarter are estimated to rise 22.3%. Peeking into 2022, S&P 500 earnings are forecasted to grow a further 9%, according to FactSet.

In bond land, the 10-year US Treasury yield rose from 0.93% at the start of the year, peaking at 1.74% in March and ending the year at 1.51%. The benign price action of the 10-year Treasury suggests investors are not anticipating long-term inflationary pressures.



By contrast, the 2-year US Treasury, a proxy for short rates, began the year at a yield of 0.12% and was flat through the first three quarters of the year. As inflation persisted and persuaded investors that the Fed would be forced to raise interest rates in 2022, the 2-year Treasury rose throughout the fourth quarter to end with a yield of 0.75%.

Across all maturities, real rates—nominal or stated rates minus inflation—are in negative territory. This does not mean the bonds are poisoned apples, exactly, but it is a challenging environment for fixed income investors, who face a potential loss of purchasing power on their bond holdings.

2022: A JUST-RIGHT ECONOMY NEEDS A SOFT LANDING

Into the woods and down the dell
The path is straight, I know it well
Into the woods and who can tell
What's waiting on the journey?
-Stephen Sondheim, Into The Woods

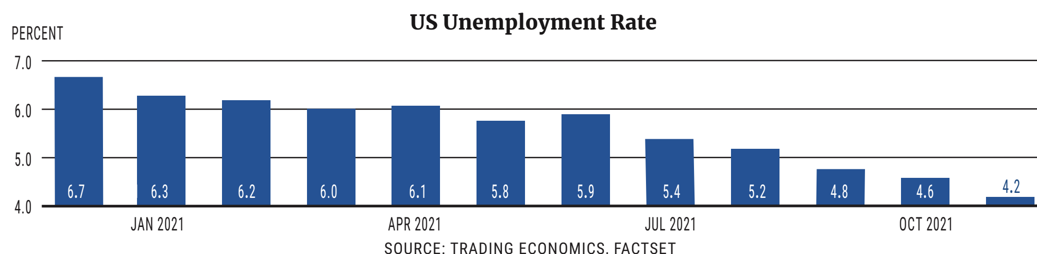
We have arrived at an interesting juncture on the road to economic recovery. Arguably, the all-of-government stimulus policies have succeeded all too well, resulting in an over-heating of the US economy, as evidenced by the highest inflation readings since 1980. It's true that the Fed would prefer to deal with inflationary challenges rather than the disinflationary/deflationary threats of the last recession. And it's also true that one way to address an excessive debt problem is to attempt to inflate one's way out of it—to use cheaper and more plentiful inflated dollars to repay bonds.

But inflation constitutes a tax on consumers, particularly on low-income households. And it is politically disastrous, especially as we begin a midterm election year.

For many months, the Fed argued that the inflationary impulse was 'transitory,' but dropped the term after transitory proved more durable than anticipated. But there is much to suggest that inflation, while running hot now, will start to decline soon, and considerably. Here are some reasons why:

- **Monetary stimulus is diminishing:** the Fed has accelerated its reduction of bond buying, and at the current rate will have ended quantitative easing in March. Interest rate increases are widely predicted to follow.
- **Fiscal stimulus is diminishing:** while the bipartisan infrastructure bill has been signed into law and the Build Back Better social infrastructure bill may not be dead, they pale in size compared to the $1.9 trillion American Rescue Plan and the $2.2 trillion CARES legislation, and funds will be spent over a number of years, not all in 2022.
- **Supply chain constraints and transportation bottlenecks are beginning to ease:** The Baltic Dry Freight index, a measure of shipping costs, declined 17% in December, and is down more than 60% since its peak in early October. The backlog of ships at the ports of Los Angeles and Long Beach waiting to dock and unload their cargoes, while still elevated, is coming down.

The challenge to getting inflation under control lies in the labor market. The labor market has healed substantially, as businesses report record unfilled job openings. Plentiful jobs have fostered the Great Resignation, as employees quit in record numbers and obtain sizable compensation boosts when they jump ship. Employers may not have resorted to kissing frogs as they search for princes to fill job vacancies, but they are raising salaries and enhancing benefits. Wages are growing handsomely, and the gains are broad-based, especially at lower compensation levels.



SOURCE: TRADING ECONOMICS, FACTSET

Unemployment has tumbled as the economy re-opened and employers sought to staff up to meet increased demand.

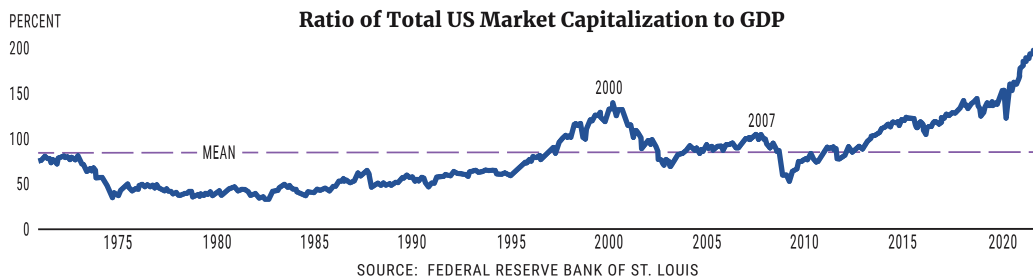
What will it take to avert a wage-price spiral, and restore balance to the labor market? For one, a higher labor participation rate—we need some folks who were forced out of the labor force (like the farm animals in *Town Musicians of Bremen*) during the pandemic to return to the ranks of the employed. For another, a drop in demand as consumers satisfy their pent-up impulses.

BREAKING SPELLS AND LIVING HAPPILY EVER AFTER

How do you ignore
All the witches,
All the curses,
All the wolves, all the lies,
The false hopes, the goodbyes,
The reverses,
All the wondering what even worse is
Still in store?
-Stephen Sondheim, Into The Woods

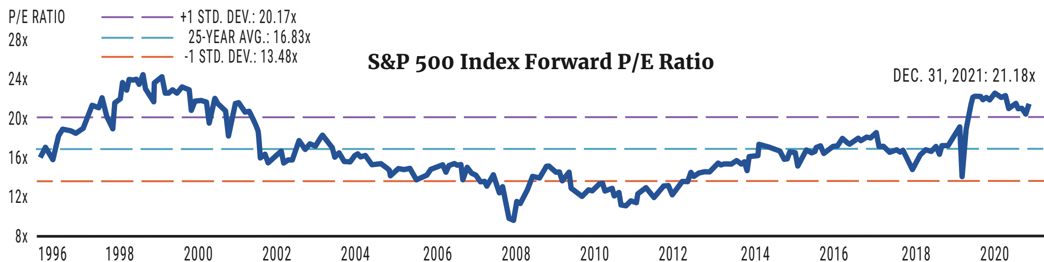
Conquering rising labor costs will be critical for the stock market in 2022, as higher expenses could erode historically high profit margins and produce some disappointments on the earnings front. With the stock market priced at 22 times expected 2022 earnings, misses may be severely punished.

By many measures, stocks are historically expensive. The chart below plots total stock market capitalization (as represented by the Wilshire 5000 Total Market Index) as a percentage of US GDP, a measure favored by Warren Buffett to determine whether stocks are attractive. On this basis, the market is at a record rich valuation.



SOURCE: FEDERAL RESERVE BANK OF ST. LOUIS

Other measures, too, suggest that stock prices are elevated, including classic metrics such as price to earnings, price to book, price to cash flow, and dividend yield.



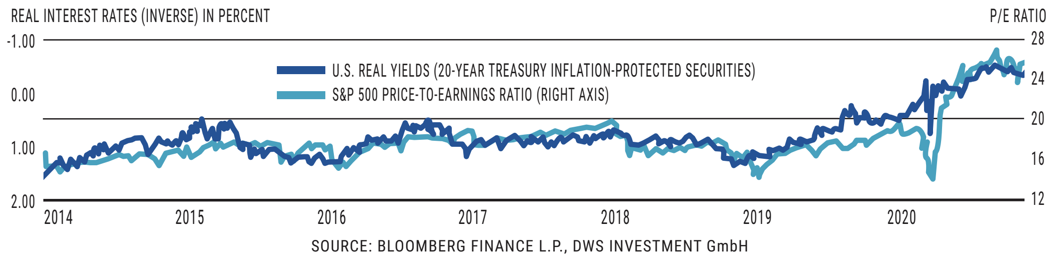
VALUATION MEASURE	DESCRIPTION	LATEST	25-YEAR AVERAGE	STD. DEV. OVER/UNDER VALUED	VALUATION MEASURE	DESCRIPTION	LATEST	25-YEAR AVERAGE	STD. DEV. OVER/UNDER VALUED
P/E	FORWARD P/E	21.18x	16.83x	1.30	P/B	PRICE TO BOOK	4.41	3.08	1.66
CAPE	SHILLER'S P/E	40.9	27.86	2.05	P/CF	PRICE TO CASH FLOW	16.17	11.11	2.30
DIV. YIELD	DIVIDEND YIELD	1.35%	2.00%	1.97	EY SPREAD	EY MINUS Baa YIELD	1.35%	0.16%	-0.60

SOURCE: FACTSET, FRB, ROBERT SHILLER, THOMPSON REUTERS, J. P. MORGAN ASSET MANAGEMENT

Investors should be nervous about this, but the absence of volatility in markets suggest they are not. Could it be that investors have been put under a spell, inducing them to pay sky-high prices?

We think not. This is where Tina comes in. As unattractive as stock market valuations may be, bond market valuations are, arguably, even more unattractive. And interest rates are a significant driver of investors' willingness to pay higher multiples for stocks. The following chart highlights the close fit between real interest rates and stock prices.

Real Interest Rates And Market Valuations Are Inversely Correlated



SOURCE: BLOOMBERG FINANCE L.P., DWS INVESTMENT GmbH

So, if in fact the Fed does act to raise interest rates this year, will Tina's charm fade? We think Tina has staying power, as the Fed is likely to be more cautious rather than more aggressive as it tightens monetary policy. This is especially likely to be the case if inflation shows signs of moderating later in the year.

That said, equity investors' best hope is if Goldilocks comes to join Tina at the party. Goldilocks, as noted, shows up when the economy grows fast enough to lift consumer spending and corporate profits but not so fast as to ratchet up inflation and force the Fed to take the punch bowl away. Any upside surprise to strategists' modest 2022 market expectations would come from such a scenario.

Taken all in all, US equities look poised for a constructive but unexciting year, supported by above average GDP growth and high single digit earnings growth. Within US stock markets, small cap value stocks are perhaps the fairest ones of all, having the most favorable risk/reward profile, with comparatively reasonable valuations and a pro-cyclical orientation.

International equities sport less extended valuations, and 2022 could be the year in which they play catch-up versus domestic stocks. International developed markets boast more modest valuations and a pro-cyclical orientation.

Real estate equities are unlikely to perform as strongly as they did in 2021. Nonetheless, retaining exposure to the asset class provides some portfolio protection should inflation continue to be elevated.

For fixed income investors, caution is warranted, as 2022 could further last year's negative total return. Spreads for corporate and high yield bonds are historically tight. Central banks around the world are lifting rates, and the Fed is preparing to attend the ball. These factors may encourage investors to shorten duration and trade up in credit quality. This may leave them Grumpy but not Dopey.

Thus, we greet the new year with a mixture of expectation and anticipation. We wish you a year of adventure, filled with colorful characters and healthy returns, free of witches' spells and downside volatility. And should Goldilocks make a hoped-for entrance, let us hope she does so without riling up the Three Bears again, as she did once upon a time.

PEAPACK PRIVATE

Wealth Management

500 HILLS DRIVE, SUITE 300, BEDMINSTER, NJ 07921
TEL (908) 234-0700 • WWW.PEAPACKPRIVATE.COM

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