CAPSTONE
FINANCIAL ADVISORS

Quarterly Investment Perspective: Q1 2022

Aldo S. Vultaggio, CFA®, CPA, AIF® | Chief Investment Officer

KEY POINTS

- Global stock markets generated significant returns in 2021, while bond markets experienced slightly negative returns. Despite increased volatility, stock markets in aggregate will likely still post positive returns in 2022; however, we expect stock returns to be lower than in recent years. Bond market returns in the aggregate are likely to be muted in 2022; however, future bond returns will increase amid higher rates.
- The economy improved markedly in 2021, expanding at the fastest pace in many years. Economic growth is expected to slow but remain above trend in 2022. Some inflationary pressure will likely ease this year, but new virus waves could still bring challenges.
- Over the past year, we've seen the rise in popularity of special purpose acquisition companies (SPACs), initial public offerings (IPOs), big tech stocks, small speculative growth stocks, and of course, cryptocurrencies. We discuss whether they deserve a larger place in portfolios.
- Stock diversification across global markets along with tilts toward relatively more profitable, less expensive, and smaller-cap companies will likely help increase the return potential for portfolios. Additionally, we outline ways that investors should position portfolios for above-trend inflation and rising interest rates over the next few years.

MARKET REVIEW

ROBUST EARNINGS AND ECONOMIC GROWTH BOOSTED STOCK RETURNS IN 2021

Global stock markets continued a relatively steady rise throughout 2021, generating significant returns and materially outperforming bonds. (See **Figure 1.**) In addition to effective vaccines and treatments, stock markets were buoyed by several other positive developments, including strong corporate earnings and high consumer spending. Analysts estimate that U.S. corporate earnings grew 45% for the entire year.[1] Big profits came as consumer spending generally trended higher throughout the year, rebounding from pandemic lows.

RISING INTEREST RATES AND INFLATION EXPECTATIONS PUSHED BOND RETURNS DOWN

Following a year in which they gained significantly and exceeded return expectations, high-grade taxable bond markets broadly finished 2021 in negative territory. An almost across-the-board rise in global interest rates caused bond prices (which move in the opposite direction of rates) to move lower.

Short-term rates increased because some central banks started raising their policy rates, while others provided new guidance that they would likely begin in 2022. Due to higher future economic growth and inflation expectations, long-term rates also increased from record low levels.

STOCK & BOND MARKET RETURNS

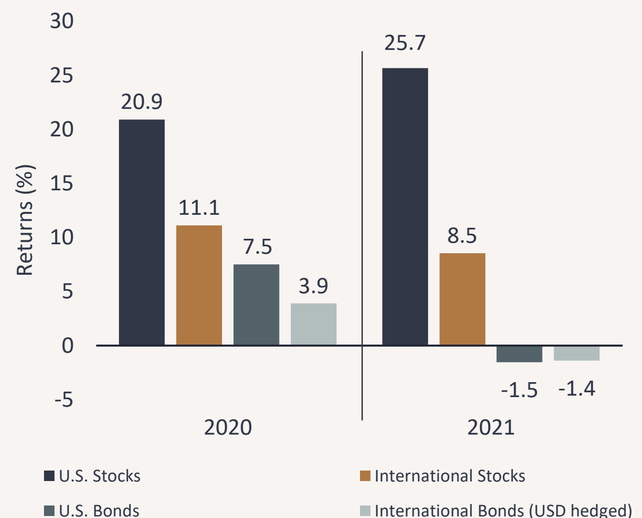

FIGURE 1. U.S. stocks significantly outperformed international equities again in 2021. More robust earnings and economic growth pushed U.S. stock markets ahead. Additionally, a significant correction in the Chinese stock market held back emerging market returns. Moreover, U.S. dollar strength (up +6.25% in 2021) reduced all international stock returns not hedged to the dollar.

Meanwhile, high-grade taxable bond markets experienced slightly negative returns. Both U.S. and international bonds (dollar hedged) declined modestly in line with each other.

SOURCE: MORNINGSTAR, RUSSELL, MSCI, BLOOMBERG. DATA AS OF 12/31/2021. SEE ENDNOTE 2 FOR ADDITIONAL DISCLOSURES.

MARKET OUTLOOK

STOCK MARKETS IN THE AGGREGATE WILL LIKELY STILL POST POSTIVE RETURNS IN 2022

Stock markets should continue being supported by stimulative central bank policies, a healthy global economic backdrop, solid corporate fundamentals, and high investor demand for stocks to earn higher returns over bonds and cash. Moreover, we expect better international stock market performance, driven by attractive valuations and a more coordinated economic growth acceleration across regions. We also expect more profitable, smaller-cap, value-oriented stocks to deliver higher returns as the global recovery continues and interest rates rise further.

WE EXPECT STOCK RETURNS TO BE LOWER THAN IN RECENT YEARS, HOWEVER

Stock market returns in the aggregate will likely be significantly lower than in recent years; global equities have averaged just over 20% returns over the last three years.[3] Going forward, however, the combination of rising interest rates, less government (fiscal) support, moderating economic and earnings growth in the U.S. (compared to 2021), full stock market valuations, and (already) high corporate profit margins may limit future equity returns to the mid-single-digit territory.

STOCK MARKET VOLATILITY WILL LIKELY BE ELEVATED RELATIVE TO LAST YEAR

In 2021, stock market volatility was relatively tame due to an improving macroeconomic backdrop combined with ample central bank monetary stimulus. Going forward, while the economy should remain on solid footing, monetary stimulus will gradually fade providing less support to financial markets overall. Additionally, virus variant risks as well as geopolitical risks (particularly in Russia and China now) could spark additional market volatility. As a result, the more speculative, expensive, and higher-risk areas of the market are likely to be particularly vulnerable.

BOND MARKET RETURNS IN THE AGGREGATE ARE LIKELY TO BE MUTED IN 2022

On the one hand, current bond yields are higher than they were a year ago, which will help overall bond returns going forward. But, on the other hand, global central banks will likely continue pivoting toward raising interest rates to combat inflation, which will put downward pressure on bond prices in the short term (and further increase bond yields).

Investors are now focused on how quickly and forcefully central banks will need to raise interest rates to curb inflation. With the ongoing pandemic, central banks will likely take a deliberate approach to tighten monetary policy. If recent past tightening cycles are any guide, central banks will take their time (arguably too much) to raise interest rates. So, although rates are likely to increase, the climb higher will likely be gradual. As such, we do not expect a scenario that would meaningfully disrupt bond markets resulting in long-term or significant losses.

RISING INTEREST RATES LEAD TO HIGHER TOTAL RETURNS FOR LONG-TERM INVESTORS

As yields rise over time, investor demand for high quality bonds will increase, underpinning bond prices. Total returns should gradually increase given the higher coupon income that bonds will deliver. Eventually, at the natural end of the economic growth cycle, bonds prices will appreciate again as rates move down again to prevent a severe recession and re-stimulate the economy.

ECONOMIC REVEW

THE U.S. ECONOMY IS ON STRONG FOOTING

The U.S. economy improved markedly over the past year, expanding at the fastest pace in many years. Consumer spending was robust throughout the year (up an average 19%[4]) despite rising prices. Jobs have been plentiful, and wages have been rising after decades of stagnant growth. (See **Figure 2**.) Amid a robust economic recovery, the Federal Reserve changed its policy guidance to tightening as a slew of new data showed price pressures rising and broadening.

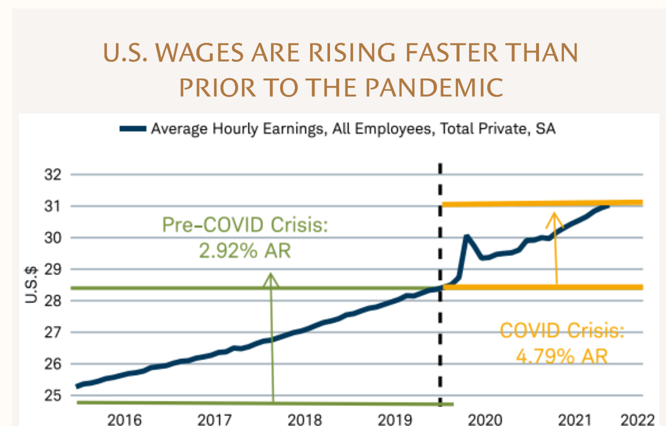

FIGURE 2. Jobs in the U.S. are plentiful and after decades of stagnant growth, wages are rising across nearly all sectors of the economy. This has contributed to significant consumer spending growth.

SOURCE: CHARLES SCHWAB, BUREAU OF LABOR STATISTICS. DATA AS OF DECMBER 31, 2021.

DESPITE A STOP-START RECOVERY, THE INTERNATIONAL ECONOMY GREW SIGNIFICANTLY

Despite a slow start and interruptions throughout the year, most major economies abroad remained on pace to reach above-average economic growth last year.

According to the International Monetary Funds' latest outlook, the entire global economy is expected to have grown 6% in 2021, versus recent historical trend growth of around 3.5%.[5] Despite worldwide supply chain issues, a regulatory-induced year-end slowdown in China, and firmer foreign government responses to the Omicron variant globally, economies abroad grew significantly. A meaningful pick-up vaccination worldwide and continued government stimulus efforts across most developed countries aided foreign economies throughout the year.

ECONOMIC OUTLOOK

ECONOMIC GROWTH IS EXPECTED TO MODERATE BUT REMAIN ABOVE TREND IN 2022

While the world still focuses on the battle against COVID-19, there are reasons for optimism in the year ahead.

Despite materially less stimulus from central banks and governments next year (particularly in the U.S.), the global economy is expected to continue growing at an above-trend pace in 2022. The next phase of economic expansion will be driven by strong household balance sheets, ample savings, low unemployment, and higher wages. However, as we move past peak growth and peak policy accommodation, the growth that follows will likely be lower than the past year and uneven across regions.

Moreover, many risks to the outlook remain, including uncertainty about the pandemic, geopolitical risk, and how policy officials handle inflation.

NEW VIRUS WAVES COULD STILL BRING CHALLENGES

The pandemic is still ongoing and will continue to present risks to the global economic recovery. However, vaccine and testing availability, the development of new medications, and a lower appetite for lockdowns may mean less severe health and economic consequences and a potentially reduced impact on financial markets. A better understanding of COVID-19, effective health policies and vaccine deployment have allowed economies to emerge from lockdowns despite successive virus waves. We think the broader trend remains toward less aggressive policy measures and continued progress toward reopening.

SOME INFLATIONARY PRESSURE WILL LIKELY EASE IN 2022

In 2021, unprecedented record government fiscal transfers to households bolstered good spending, causing a surge in commodity prices and trade bottlenecks that unleashed the highest headline inflation for decades across developed markets. The inflation price surge in many commodities and goods is expected to ease (or even reverse some) in 2022 as fiscal policy support ends (dampening consumer demand) and supply constraints improve. (See **Figure 3**.) However, more persistent sources of price pressure such as rising wages, rent, and medical care will likely remain elevated.

As such, inflation measures should start to decline from current high levels, particularly once the 2020/early-2021 base effect wears off. However, core inflation is likely to return to a 2.5% to 3.5% pace, rather than the 2% or lower level that existed before the pandemic.

WORLD CONTAINER SHIPPING COSTS HAVE STARTED TO DECLINE

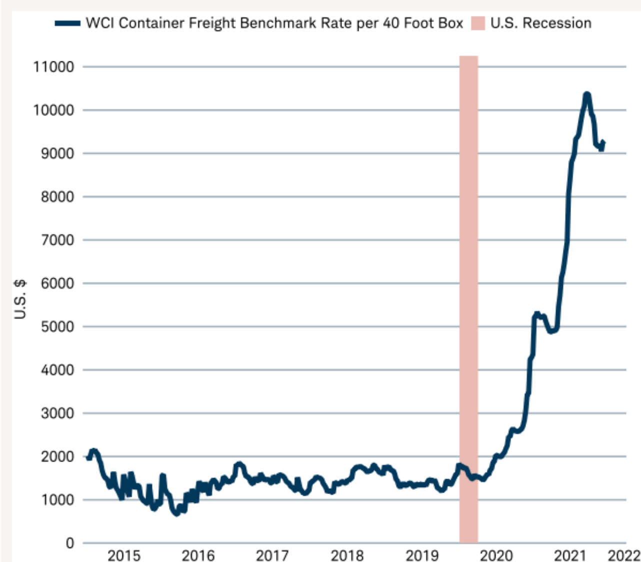

FIGURE 3. The average cost of shipping a standard large container (a 40-foot-equivalent unit) surpassed $10,000 in 2021, four times than the year prior. However, global container shipping costs have come down from the peak and may indicate that supply chain disruptions are starting to ease.

SOURCE: CHARLES SCHWAB, DREWRY. DATA AS OF DECEMBER 31, 2021.

ON THE MINDS OF INVESTORS

TECH STOCKS, SPAC'S, IPO'S, CRYPTOCURRENCIES - SHOULD I CHANGE MY INVESTMENT STRATEGY IN 2022?

Over the past year, we have seen the rise in popularity of special purpose acquisition companies (SPACs), initial public offerings (IPOs), big tech stocks, small speculative growth stocks, and of course, cryptocurrencies. This popularity of individual stocks (SPACs, IPOs, meme stocks, etc.) and crypto investments (coins, tokens, etc.) is prompting many investors to wonder whether they deserve a larger place in their portfolios.

First, when it comes to investing in individual stocks, our answer is usually "yes," but in the proper proportions.

We strongly believe that the best way to allocate to stocks is to broadly diversify across thousands of companies in proportions close to their size relative to the entire stock market. Deviation from these proportions should be minor and toward relatively more profitable and less expensive stocks that have historically delivered higher returns over long periods. This diversified and rightsized approach to investing in stocks has typically delivered better returns over long periods, often with significantly less risk than portfolios with concentrated exposure to a few stocks.

Second, when it comes to investing in cryptocurrencies, our answer depends on an investor's goals, risk appetite, and understanding of the investment.

From a goals perspective, cryptocurrencies may be more appropriate for investors with a very long investment horizon, low liquidity needs, and a high-risk tolerance. While some cryptocurrencies have significantly outperformed traditional assets recently, their returns have come with an extreme amount of risk. Given their volatility, an allocation to cryptocurrencies should not be considered a core component of a portfolio; if anything, it should be limited to a very small percentage of a portfolio's risk asset allocation. But regardless of the size, an allocation to cryptocurrencies should be considered money that will not be needed for the foreseeable future and would not materially impact an investor's financial plan, should the asset's value go to zero.

Like with any investment, an investor should fully understand the cryptocurrencies they invest in, including their adoption and future use cases as well as the potential risks (regulatory, security, obsolescence, etc.) that can curb their adoption. This knowledge can help an investor stick with the investment through the good and the bad times, which come in huge waves with cryptocurrencies.

In short, concentrating your portfolio in a few stocks or cryptocurrencies—like focusing on any small number of investments—can expose investors to substantial risk. Even if you manage to find a few winners, research argues that good luck is unlikely to repeat throughout a lifetime of investing. For every individual who got into and out of a stock or cryptocurrency at the right time, there's likely another who bought or sold at the wrong time; we only hear and read about the "winners." There's no shortcut for growing wealth, and academic research suggests that potential success in the market is predicated on a robust investment approach, a long-term perspective, and the self-control to stay invested.

We continue to recommend using established asset classes (stocks, bonds, real estate, infrastructure, and other alternative investments) and time-tested strategies (strategic, diversified, low cost, tax efficient approaches) as the core of portfolios. These types of investments and strategies have proven to build and preserve wealth consistently overtime, whereas more speculative, concentrated investment strategies typically have a much wider range of outcomes. So, while there may be a place in your portfolio to dabble in these types of investments, we believe they deserve a much smaller place as part of an overall diversified, rightsized strategy.

PORTFOLIO MANAGEMENT

POSITIONING STOCKS FOR POTENTIALLY LOWER MARKET RETURNS

As noted earlier, stock market returns in the aggregate will likely be significantly lower than in recent years.

Stock diversification across global markets will likely help increase the return potential for portfolios. We think 2022 could be the start of better international stock performance, driven by solid fundamentals, attractive valuations, and more coordinated economic growth acceleration across regions. As such, stock allocations will maintain an increased allocation (~30%) to international stocks, diversified across many other developed and emerging market countries.

In addition, tilts toward relatively more profitable, less expensive, and smaller-cap stocks should continue to bode well for portfolio returns. Although larger-cap growth stocks had another solid year in 2021, smaller-cap value stocks across various cyclical sectors significantly narrowed the gap. We expect these types of stocks to continue providing strong relative performance over the next few years as the global recovery continues and interest rates climb higher. As a result, we will continue to tilt toward these stocks modestly, but at the same time, still maintain meaningful exposure to larger-cap stocks and growth sectors for diversification purposes.

POSITIONING PORFOLIOS FOR ABOVE-TREND INFLATION

As noted earlier, inflation is currently expected to remain higher than 2% over the next few years.

Given current (and potential future) inflation risk, we will continue to keep cash levels down to a minimum in portfolios and recommend that clients maintain low cash levels in outside accounts.

For stock allocations, we think portfolios should include diversified allocations across various sectors, including energy, materials, and utilities. These sectors tend to do particularly well in an above-trend inflationary environment because of their ability to pass on price increases to consumers and businesses.

Additionally, we will continue to allocate toward real assets like real estate and infrastructure equities, which tend to provide increased inflation protection to portfolios via rising rents and contracted cash flows that are often automatically adjusted with inflation. In addition, we expect real estate and infrastructure to continue their strong performance with the ongoing resumption of global economic activity and significant investment in (and high demand for) these assets.

POSITIONING BONDS FOR RISING INTEREST RATES

Bond portfolio diversification and active management will help to mitigate the risk of rising rates. Diversifying across bonds with different levels of interest rate sensitivity will help to hedge interest rate risk. Portfolio bond allocations will continue to be diversified across various bond sectors (beyond government bonds), bond maturities (with an intermediate-term weighted average), credit qualities (with a tilt toward mid-grade), and countries (~30% outside of the U.S.).

Moreover, actively managed strategies with the latitude to allocate more to credit sectors and mid-grade bonds (including some high-yield bonds) will provide some additional protection against future interest rate increases while still maintaining a high-quality bond profile to protect against inevitable stock market volatility.

Rising interest rates will provide the opportunity to purchase bonds paying higher yields. When interest rates rise, rebalancing and ongoing interest and principal reinvestment enable investment in bonds at lower prices (hence higher interest rates). Over time, this systematic approach, which we implement in client portfolios, will help to increase the income yield component of future total returns for bonds and portfolios. The higher yields on reinvested cash flows can outweigh the short-term market decline over the long term, particularly for investors who plan to maintain their positions for longer than their bond portfolio's duration.

SOURCES & ENDNOTES

[1] Factset: https://insight.factset.com/sp-500-cy-2021-earnings-preview-record-high-earnings-and-sales-growth-in-cy-2021.

[2] U.S. stock returns are represented by the Russell 3000 Index. International stock returns are represented by the MSCI ACWI Ex USA IMI. U.S. bond returns are represented by the Bloomberg Aggregate Bond Index. International bond returns are represented by the Bloomberg Global Aggregate Ex USA Hedged Index.

[3] Morningstar Direct: The global stock market represented by the MSCI ACWI USA IMI Index had a 3-year annualized return of 20.20% through 12/31/2021.

[4] Census Bureau, YCharts: Seasonally adjusted U.S. retail sales averaged 18.69% year-over-year increase based on monthly readings from January to December 2021.

[5] International Monetary Fund: www.imf.org/external/datamapper/NGDP_RPCH@WEO/WEOWORLD

Past performance does not guarantee future results. Indices are not available for direct investment; therefore, their performance does not reflect the expenses associated with the management of an actual portfolio.

IMPORTANT DISCLOSURE INFORMATION

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CAPSTONE
FINANCIAL ADVISORS

Capstone Financial Advisors, Inc.
2001 Butterfield Road, Suite 1750
Downers Grove, IL 60515
Phone (630)241-0833
Fax (630)241-0834