The Cobblestone Advisor
Investment Brief
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COBBLESTONE
CAPITAL ADVISORS

2021: Expectations vs. Reality

The turn of the calendar to a new year provides an ideal opportunity to reflect on the past and chart a course for the future. In that vein, we wanted to take this opportunity to reflect on our expectations at the outset of 2021 versus the reality that unfolded, and provide a look ahead to what we believe comes next for markets and the economy.

In our January 2021 Investment Brief, we highlighted lofty investor expectations heading into the new year and questioned whether they would be met as the year unfolded or whether developments would fall short, setting the stage for a market pullback.

We identified several potential catalysts that were likely to determine the path forward. They centered on the rollout and uptake of COVID-19 vaccines, a return to more normal living conditions, continued fiscal and monetary stimulus to help keep financial conditions easy, the potential for a release of pent-up demand amid elevated consumer savings rates, and an economic backdrop supportive of corporate profitability that would allow earnings to grow into elevated valuations and push equity markets higher.

While we noted the plausibility of a more normalized growth backdrop in 2021 resulting from at least a few of these catalysts manifesting, the reality is that each catalyst identified materialized at least to some extent over the course of the year, providing fundamental support for both the economy and financial markets. As a result, the recovery in aggregate economic activity, persistence of above-trend growth, and strength in risk asset returns was sharper, longer enduring, and more resilient than we envisioned.

To be sure, 2021 was in some ways a 2020 redux in that it remained a difficult year for many, both personally and economically. COVID cases ebbed and flowed, and the resulting reimposition of lockdowns and tighter restrictions across many geographies strained supply chains and forced business closures. Even so, the rollout and uptake of vaccines ushered in somewhat more normal living routines, and though weakness persisted in certain economic segments, it was offset by strength in others as fiscal and monetary authorities continued to offer targeted stimulus as and where needed.

Bolstered by elevated savings rates resulting from easy money policies, consumer spending remained exceptionally robust throughout the year, and corporate profits spiked to $2.7 trillion, by far an all-time high and up 39% compared to levels just prior to the onset of the pandemic. These dynamics led to an economy at large that performed extraordinarily well, with both US and global GPD growth persisting at above-trend rates throughout the year.

The combination of a strong economic recovery and accommodative monetary policy fueled healthy returns in risk assets. After posting double-digit returns in 2020 (+18.4%), the S&P 500 continued its climb in 2021, notching 70 record highs on its way to a 28.7% gain for the year, marking the third consecutive year of robust double-digit returns for equities.

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Total Return (%), Ending 12/31/2021				Annualized		
	Qtr	YTD	1 Year	3 Years	5 Years	10 Years
S&P 500 Stock Index	11.03	28.71	28.71	26.07	18.47	16.55
Russell 2000 (Small-Cap Stocks)	2.14	14.82	14.82	20.02	12.02	13.23
MSCI EAFE (International Stocks)	2.69	11.26	11.26	13.54	9.55	8.03
MSCI EM (Emerging Markets)	-1.31	-2.54	-2.54	10.94	9.88	5.49
Bloomberg Barclays US Aggregate Bond Index	0.01	-1.54	-1.54	4.79	3.57	2.90
Dow Jones US Select REIT	17.23	45.92	45.92	16.82	9.64	10.69
Consumer Price Index (% Chg over Period; One-Month Lag)	1.60	6.71	6.81	3.32	2.86	2.08

Bonds, meanwhile—with the exception of TIPS—experienced negative returns in 2021 as yields generally rose amid a strong economic backdrop. For the broad US fixed income market, the -1.5% return marked the first calendar year decline since 2013.

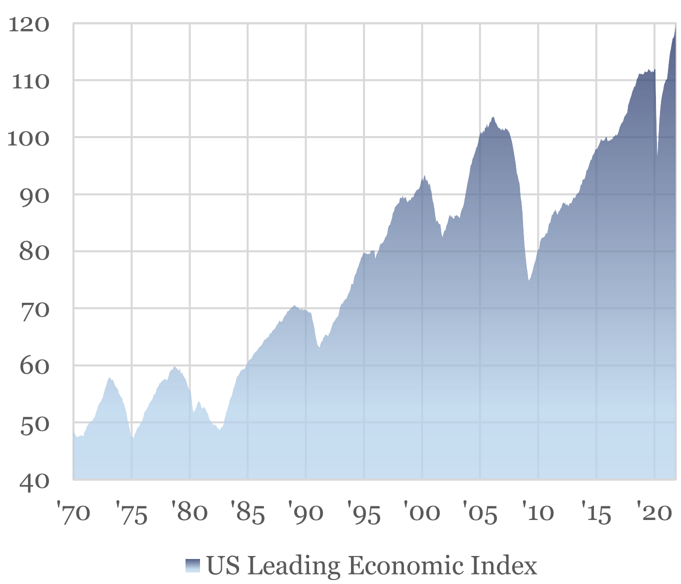
Looking Ahead to What's Next

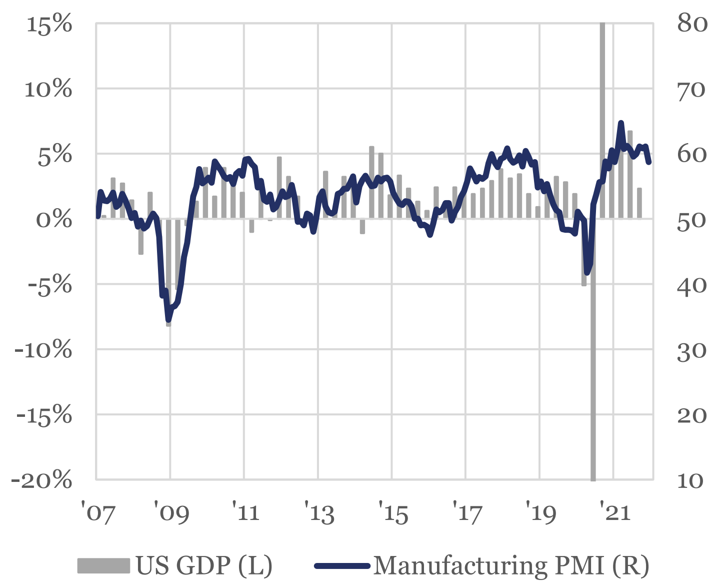
As we consider what lies ahead, we see several headwinds and tailwinds to economic growth and financial markets. How developments related to these catalysts play out will likely shape the investment environment in 2022. The current surge in COVID case counts is the first headwind on our list. Indeed, the evolution of the pandemic will remain a key driver of economic and market outcomes in the quarters ahead. Waning fiscal stimulus, tightening Fed policy, and elevated valuations pose additional headwinds.

On the flip side, tailwinds including healthy consumer balance sheets, strong corporate profits growth, and robust GDP growth should help offset any headwinds that emerge. Importantly, economic indicators support the narrative of continued strong growth ahead. The Leading Economic Index rose sharply in both October and November, while the Purchasing Managers' Index—though down from its 37-year high reached in March—also remains elevated (see exhibit below). Although growth has modestly softened, these leading economic indicators suggest that the economic expansion will continue at an above-trend rate in 2022.

Additionally, waning fiscal stimulus and tightening Fed policy that we highlighted as headwinds have the silver lining of helping to dampen inflationary pressures. We anticipate supply chains beginning to heal, economies continuing to reopen—especially manufacturing and export-driven emerging markets—and secular headwinds to inflation persisting (i.e., the disinflationary forces of technology, globalization, demographics, and the declining power of labor versus capital). We believe the resulting environment will be conducive to inflation eventually normalizing.

Taking all of this into account, we believe that the backdrop in 2022 will be favorable for investors. We do, however, expect higher volatility and more modest returns compared to the relative calm of 2021 and heady performance of the last three years. Coming off of a year during which highly accommodative monetary policy helped subdue market gyrations, we anticipate increasing volatility as the Fed begins to unwind the easing measures put in place early on in the pandemic. A well-diversified portfolio, incorporating uncorrelated alternative asset classes (including private investments) such as real estate and other real assets can help counteract the effects of swings in the market should they materialize.





Source: US Conference Board, Institute for Supply Management, US Bureau of Economic Analysis, Bloomberg.