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Minot DeBlois Advisors LLC
2021 Review and Investment Outlook
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"Investors know better than to take year end predictions from anyone at face value."

Financial Times, December 23, 2021

Given the complexity of the financial markets, investors are well-advised to bear in mind this rather cynical observation from the *Financial Times*. Nevertheless, one's outlook for the future and the impact of recent events in many ways determine one's actions today, and in this letter we will provide what we hope will be useful insights into both our outlook for the new year and our assessment of where we stand in the economic and market cycles at the end of 2021.

The past year was a remarkable one in equity markets by almost any measure. As shown in the table below, U.S. equities (as represented by the S&P 500) performed especially well, while bond markets worldwide were generally weak. Equities' strong showings came despite the tragic toll taken by the COVID-19 pandemic, the highest consumer inflation rates recorded in years, and severe strains placed upon the political and manufacturing capacities of many large economies.

Major Asset Class Indices[1]	Total Return One Year	Annualized Return 5 Years	Annualized Return 10 Years
S&P 500 Index (U.S. Large Cap Stocks)	+28.7%	+18.5%	+16.5%
MSCI EAFE Index (Foreign Developed Large Cap Stocks)	+11.3%	+9.6%	+8.0%
Barclays Aggregate Bond Index (U.S. Investment Grade Bonds)	-1.5%	+3.6%	+2.9%
US Short-Term Treasury Bills (Money Market Fund)	+0.1%	+1.1%	+0.6%

It was not apparent in January of 2021 that the conditions were in place for a stock market rally. In retrospect, a powerful combination of rebounding economic growth, strong demand for the products of a fairly modest number of mega-cap companies, the ability of the management and employees of these companies to execute under difficult conditions, and low interest rates provided the fuel that the U.S. market in particular needed to rise by more than a quarter.

U.S. stocks outperformed foreign equities and domestic bonds for the eighth out of the past nine years, driven in part by the continued outperformance of mega-cap technology companies, which tend to be concentrated in the U.S. Impressively, during 2021 the S&P 500 recorded 70 all-time highs, which is second only to 1995, with only 5 days with a decline of more than 2%.

Evidence of the importance of mega-cap stocks to the market's return is found in the fact that, of the $8.9 trillion in market cap added to the S&P 500 last year, 32% was due to advances by just five of the largest technology-related stocks: Apple, Alphabet (Google), Tesla, Microsoft and Nvidia. In fact, the largest companies outperformed their smaller counterparts by more than 10 percentage points, which was the widest gap in almost 15 years, according to Morningstar.

The ability of the world's economies to continue to rebound from the pandemic's effects will be a key determinant of corporate profit growth in 2022. Economic growth will also depend upon the extent to which inflation can be brought under control and the facility of central banks and major governments in managing monetary and fiscal policy. Several economists have noted that central banks face a particularly daunting task in withdrawing stimulus sufficiently to bring down inflation, but not so much as to cause economic growth to falter.

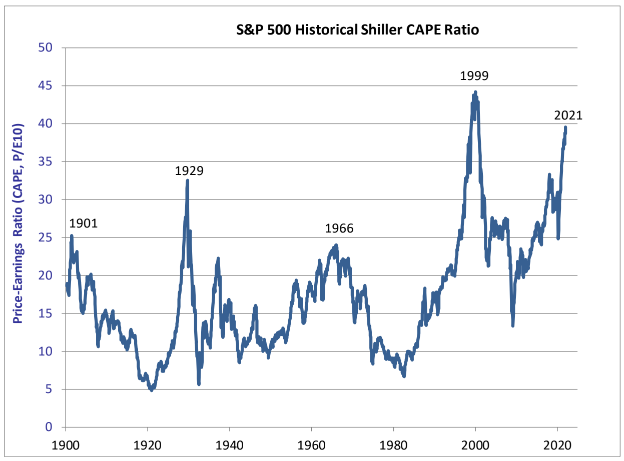
The bull case for equities relies at least in part on the argument that the positive market conditions seen in 2021 will continue, and that the world will successfully navigate the challenges that lie ahead. While it is true that U.S. corporate

[1] The S&P 500 Index is a broad measure of U.S. large capitalization stocks; the MSCI EAFE Index (Net) is a broad measure of mid-large cap stocks in developed international markets; the Barclays Aggregate is a broad index of U.S. investment grade bonds; the 90-Day U.S. Treasury Bill represents short-term government money market funds. Returns are provided by sources deemed to be reliable but are subject to change or revision.

profit growth in 2022 will most likely be above its long-term average, in addition to the trajectory of the pandemic, three considerations give us pause:

- *Inflation and interest rates* – At some point inflation will need to moderate in order for interest rates to remain as low as they have been. The pressure for prices to continue to rise will probably abate as supply constraints are overcome and manufacturing conditions return to normal; however, stubbornly high energy prices, rising wages and the costs of dealing with COVID do not augur well for price stability. In 2022, bond investors must also deal with a sea change in monetary policy, as major central banks around the world take steps to rein in rising prices.

- *Valuation* – As has been widely reported in the financial press, by a number of measures equities are extremely expensive. For example, the cyclically-adjusted price-to-earnings (P/E) ratio developed by Robert Shiller is currently above all but one of the levels Dr. Shiller has calculated going back to 1880 – the exception being December of 1999 during the technology stock bubble. Stocks can, for a time, continue to rise even if they appear over-valued by measures such as these, but longer-term returns from points of peak valuation are generally below historical averages.



- *Uncertainty* – At its core, risk is uncertainty, and as we enter 2022 the risks investors face seem especially high. The longer the world struggles with the COVID-19 pandemic, the more permanent – and difficult to predict – its effects will be. As noted, stated central bank policy is about to undergo a sea change, and governments around the world are struggling to deliver an effective response to the Omicron variant. Looking ahead, important elections loom in the United States, France, Brazil and several other countries, while manufacturers face continued supply disruptions and rising labor and other input costs.

A stock market that is expensive by historical measures amid high levels of risk and uncertainty is a combination that should give long-term investors in particular pause for thought. In light of these and the other considerations discussed above, we are carefully monitoring asset allocations and risk metrics, keeping equity weights at strategic levels and trimming stocks that appear especially over-valued. We realize that, with stocks having performed so well, selling securities can be an expensive proposition for taxable accounts, but we believe that the disciplined rebalancing of portfolios into safer assets such as cash and short-term bonds lays the groundwork for superior risk-adjusted returns. Over the long term, the potential returns of a diversified, managed portfolio of high-quality stocks and bonds should compensate investors for the inevitable uncertainty present in the economy and capital markets.

Most importantly, we wish all of our clients, friends, and colleagues a **safe, healthy and happy new year**.

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