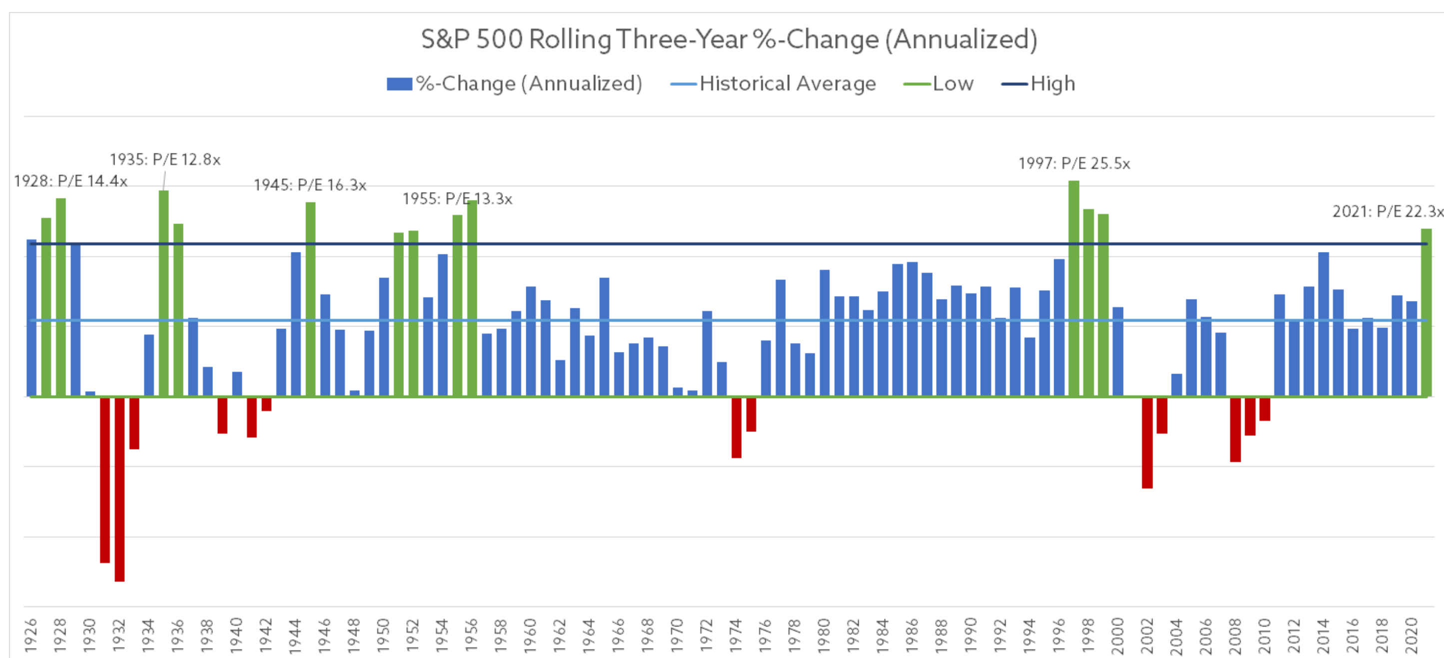
PENDLETON STREET
BUSINESS ADVISORS

Pendleton Street Advisors
4th Quarter 2021 Investment Commentary
January 15, 2022

Index Returns	4th Quarter	Trailing Twelve Months
S&P 500 US Large Cap Stock Index	11.0%	28.7%
Russell 2000 Small Cap Stock Index	2.1%	14.8%
MSCI All Country World Ex-USA Stock Index	1.8%	7.8%
Barclays Capital US Aggregate Bond Index	0.0%	-1.5%
US Core Consumer Price Index - (Inflation)	1.4%	5.0%

After a shaky start to the quarter, the S&P 500 index of US large-cap stocks resumed its upward trajectory and added another 11% to end the year at an above-average increase of 28.7%. On the other hand, bonds in aggregate delivered a flat year, with the BarCap US Aggregate Bond Index returning 0.0% as yields faced upward pressure. Heading into 2022, we see investors beginning to place more significance on economic and company-specific fundamentals (as opposed to growth sentiment and price momentum) as shifts in core drivers of value take hold. Shifting expectations around Interest Rates, Inflation, and Growth can drive large changes in how markets view and value stocks, bonds, and everything in between. In this quarter's commentary, we discuss all three drivers, particularly as they relate to the stock market and our approach to equities in client portfolios.

The S&P 500's return of 28.7% in 2021 is nearly 2.5x's the historical annual average since 1926. But the index has been increasing at double-digit rates for three years running. In fact, it has grown at an annualized rate of 24% over the last three years – a level of 3-Year growth that last occurred in 1999. Before that, investors tracking the index would have had to wait 40 years from 1957 to 1997 to achieve that level of growth over any 3-year period. While it can be tempting to look at a run like this and assume that it cannot continue (*see Gambler's Fallacy*), the truth is that it has in the past and can in the future. We believe the more important question is: **What would have to change about economic and financial conditions to cause a change in market direction?**

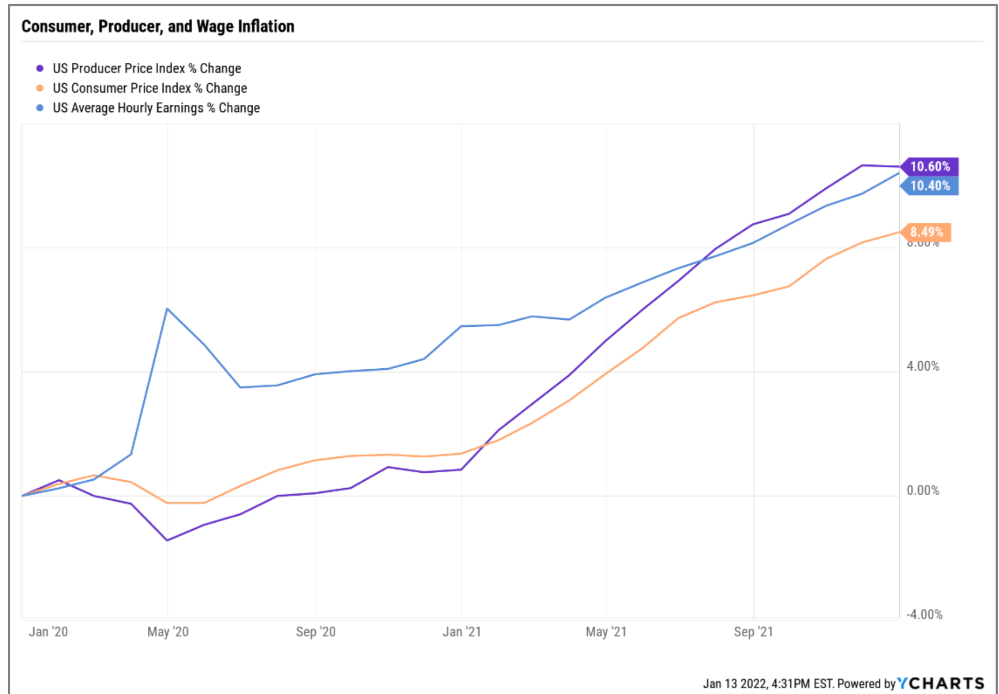


In the short-term, markets routinely over-react to fears and hopes about what ***might*** happen. In the longer-term, equity performance is significantly tied to actual, realized changes in the core value drivers like interest rates, inflation, and economic/earnings growth.

The Price-to-Earnings ("PE") Ratio - the most commonly cited valuation ratio for publicly traded companies is far from perfect, but it is useful primarily to gauge where stocks trade relative to their underlying fundamentals. PE ratios have very little predictive power over short-term periods, but the relationship over longer-term periods is clear: the higher the PE ratio, the lower the returns going forward – all else the same.

At 21.18x, the index's PE ratio sits about 30% above its long-term average of 16.83x. All else the same, we would expect lower returns going forward at this above-average valuation. A higher PE ratio typically indicates that investors expect a high rate of growth in earnings and/or lower volatility longer. Whether as a result of lofty growth expectations or a shock that interrupts growth, it is clear that starting from a higher valuation normally results in lower realized returns over the next five years. But "all-else" is never "the same."

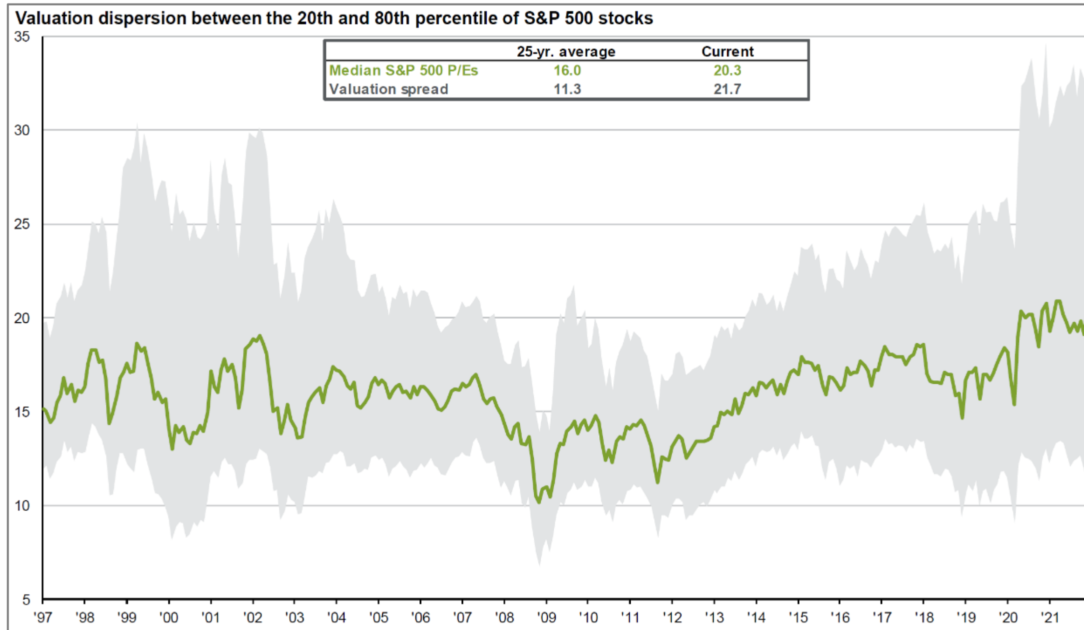
	Market Impact of driver...		**Examples of impacts on...**		
Core Driver	**Rising**	**Falling**	**Economy**	**Companies**	**Investors**
Interest Rates	↓	↑	Higher interest rates reduce disposable income and increase borrowing costs for consumers, who in aggregate are responsible for approximately 70% of US GDP. Higher interest rates also reduce consumers' propensity to spend, because saving (rather than spending) results in earning a higher return on cash & cash equivalents.	For companies, higher interest rates translate to higher borrowing costs which means if they need capital they must either issue equity (increasing supply and putting downward pressure on prices), or take on more debt at a higher cost (ending up with less after-tax earnings, and potentially a lower price relative to those earnings).	As interest rates increase, investors can find higher-yielding investments that are less volatile than stocks. As preferences shift, sellers (supply) of equities begin to outweigh purchasers (demand), resulting in lower prices.
Inflation	↓	↑	Higher inflation pushes prices and spending higher in the near term, but persistently high inflation results in slower growth. For example, if it is generally believed that inflation will continue at higher rates indefinitely, people feel better off buying at today's "lower prices." But, if inflation indeed remains high, people begin to save more and spend less in order to make up for the loss of purchasing power of existing savings.	Periods of high inflation have historically been difficult for stocks in aggregate, but the impact varies greatly based on a company's business model. Some businesses are unable to raise prices to their to cover their own rising costs, putting downward pressure on earnings and driving their stock lower in price. Conversely, some businesses can and do raise prices to offset rising costs, without sacrificing overall growth in revenue.	Aside from declining economic growth resulting from prolonged periods of high inflation, many equity investors view some inflation as a tailwind. Stock valuations are based on price relative to the value of future earnings/cash flows. Companies that are able to continue growing while maintaining profit margins should in turn be able to maintain and grow their stocks' values.
Economic Growth	↑	↓	Strong economic growth typically translates to higher employment, growth in disposable income, and more consumer spending.	When the economy is growing quickly, companies may benefit from the ability to grow profit margins by increasing productivity relative to capacity. They may also invest more aggressively by building or acquiring more capacity.	Investors prefer stronger economic growth because of the benefits growth provides for companies (see left). Markets may turn in the opposite direction of economic growth if central banks begin tightening monetary policy via higher interest rates.



Where are we now? The core drivers outlined above are ever-changing, but heading into the new year it looks as though all three are at critical turning points:

- **Growth & Inflation:** S&P 500 earnings are expected to grow at around 9.8% in 2022, which is moderately higher than the average rate of earnings growth historically. We believe 9.8% growth is realistically possible in 2022, but a couple of headwinds are gaining strength.
    - Wage pressure: As the labor market continues to tighten and skilled/willing workers become increasingly difficult to find, companies are increasing wages to find the employees they need.
    - Producer Price Inflation: If the cost of raw materials and other inputs continues to increase more quickly than consumer prices, businesses may generate less earnings even as their revenues grow. The primary unknown as we see it is whether inflation is the result of scarcity in raw materials related to supply chain issues, or if it will persist broadly even after producers get the kinks out of their supply chains.
    - Economic Slow-Down/Recession: It is not difficult to imagine the Fed pushing the economy into recession by tightening monetary policy too much and/or too quickly (*see next point*). If tightening monetary policy drives consumers to save more and spend less, businesses that depend on consumer spending will suffer declining revenue, which will then impact other sectors that count consumer-focused businesses as their customers. This represents a "vicious cycle" resulting in companies cutting headcount, which then drives consumer spending down further. Given the Fed's historical sensitivity to market volatility, the risk is that the Fed does not stop raising rates soon enough.
- **Interest rates**: Rates are still historically low, but the Federal Reserve recently indicated that it expects to raise short term rates by a full percentage point over the next four quarters. Markets have already been responding to the expectation for higher rates, as the S&P 500 has declined by 2% year-to-date through January 13th. Assuming that earnings growth meets expectations, and that those expectations are already priced into the market, a 1% increase in interest rates translates to an 18% reduction in the value of the S&P 500 from its 2021 year-end level.

While valuation at the index level may seem challenged based on current conditions, it is important to remember that the index represents 500 of the largest US publicly traded companies… not the other way around. Within the index, valuations vary greatly which provides opportunities for those willing to drill down into company-specific fundamentals in order to find underappreciated companies. As the accompanying chart illustrates, the differences in valuation between the highest-PE and lowest-PE stocks in the index are at historical highs, meaning that high quality companies trading at a discount to fair value are still there to be found.



Portfolios: 2021 was a good year for portfolio returns, as they continued to benefit from rising equity prices despite being weighed down by lackluster bond performance. Going forward, we are highly focused on managing interest rate risk in the portions of portfolios allocated to bonds. If we were not already focused on high credit quality, we would also begin focusing more on that as both equity and bond markets have begun to shy away from lower credit-quality issuers with low-to-no cash flow generation. As always, in the equity portions of portfolios we are intently focused on making sure we understand the impacts of any changes in the fundamentals of companies already in portfolios in addition to seeking opportunities to add new high quality holdings to portfolios when they are priced cheaply or fairly relative to their fundamentals.

Our firm values frequent communication with you to discuss changing conditions and to ensure that we understand and stay updated on your objectives. Our client-service staff will be reaching out to you as usual to schedule a meeting. If you would like to set up a meeting sooner, please contact us at your convenience. We look forward to hearing from you.

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