HUDSON ADVISOR SERVICES, INC

OUR VIEW OF THE MARKET

By William N. Hudson, Jr., David D. Burrows, William Hudson III, Evan Coppola, & Jeremy Hudson

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We enjoyed an article in the *Wall Street Journal*: "Forget About Trying to Forecast 2022." The point was that we have too many unprecedented and unusual forces at work in the economy and financial markets right now to predict one year ahead.

We identify with that hesitancy about forecasting. Our own commentaries throughout 2021 were more cautious than what actually occurred. We did not anticipate the double-digit performance of all the major stock indexes, or the S&P 500 setting all-time highs on 70 days. We are indeed happy for this actual outcome – but were often surprised by the market's prevailing positivity in the face of so many swirling events.

We read a survey by *Bloomberg News* of what 50 major asset managers are predicting for 2022. We are interested to see major concerns that reflect our own inherent caution. The rip-roaring stock rallies powered by the economic reopening are over. Most analysts expect the market to be positive, but to provide single digit returns in 2022. The ongoing pandemic is not a major concern. The much bigger worry is inflation and the response of the Federal Reserve. Analysts understand that monetary tightening by the Fed historically dampens asset prices.

So we approach 2022 highly cognizant of risk – but also appreciative of opportunities. Throughout 2021 there was considerable sector rotation as investors looked at different parts of the market. At Hudson Advisors, we will be looking to find our clients some "juice stock" along with our primary focus on long-term value.

MARKET TRENDS

The accompanying chart summarizes stock and bond market trends for the fourth quarter and full year 2021. Stock prices soared while the bond market struggled.

Equity Market: The stock market moved steadily higher during the first 8 months of the year, slumped in September, but then showed a strong fourth quarter. The dominant story was the market's ability to absorb and move beyond any bad news related to the prolonged pandemic. This confidence was boosted by healthy economic growth and, most particularly, by an expected year-over-year rise of 45% in the profit of S&P 500 companies.

The Dow Jones Composite Average was ahead 5.71% for the fourth quarter and 23.57% for the full year. The S&P 500 was spectacular with a gain of 11.03% for the quarter and 28.71% for the year. The Nasdaq Composite was also impressive with an advance of 8.45% for the quarter and 22.18% for the year. The "laggard" index was the Russell 2000 -- with smaller companies feeling more negative impact from Covid- and thus a 2.14% gain for the quarter and 14.82% for the year.

Fixed Income Market: Bond prices fluctuated during the year. By the end of December, however, bond investors were demonstrating obvious anxiety about the possibility of structural inflation. The yield on the 10-year Treasury bond (which moves inversely to prices) had ended 2020 at .931% and reached a post pandemic high of 1.749% on March 31. It then bounced around during the third quarter reaching a low of 1.173% on August 2 before settling at 1.512% on December 31. It has moved still higher in early January.

MAJOR MARKET INDEXES

	YTD Return
Dow Jones Composite Average TR	23.57
S&P 500 Index TR	28.71
Russell 2000 Index TR	14.82
NASDAQ Composite TR	22.18
EAFE Index NR	11.26
Bloomberg Aggregate Bond Treasury TR	-2.32

Source: Morningstar® as of December 31, 2021

THE OUTLOOK

The Economy: The stock market was buoyed in 2021 by a healthy economic recovery. The Conference Board estimates the U.S. economy grew at 5.6% in 2021. This expansion was fueled by the accommodative Fed policies, by the fiscal stimulus packages, and by vibrant consumer spending. Looking ahead, the Board forecasts GDP growth of 3.5% in 2022 and 2.9% in 2023.These future forecasts are below the expansion from the pandemic recession – but still higher than the average 2% growth of the preceding decade. The current surge of the Omicron variant is causing considerable disruption. But most economists do not expect this surge to have much negative impact on the overall GDP number for the year.

But problems exist and the health of the economy is filled with caveats. The biggest problem is inflation which has been running at an annual rate over 6%. Most economists had called this inflation "transitory"- related to the re-start of the economy -- but now the view is to expect a more sustained trend. We face complicated issues in the global supply chain and in workforce participation: both of which drive prices higher in ways that feed on the spiral. Thus, we see the Fed shifting its policies to tighter money in 2022 by ending its bond purchases and incrementally raising interest rates.

The Market: The participants in the *Bloomberg News* survey identified three major forces that will keep the market more subdued in 2022 than in the year just passed.

First, stock prices are now very rich. The current S&P 500 10-year P/E ratio is 39.2. This is 96% above the modern-era market average of 19.6.

Second, profits at big U.S. companies are expected to increase far more slowly this year compared to the 2021 surge. Analysts estimate that earnings from S&P 500 companies will rise 9.2% in contrast to the 45% profit growth last year. While positive, this growth rate is not enough to do have much effect on the high P/E ratio.

Third, and most important, is the announced change in Federal Reserve policy intended to stabilize prices. The market has been hugely sustained in recent years by the almost 0% interest rate polices of the Fed. Higher rates can hinder the stock market as borrowing costs becomes more expensive for business and consumers. The market has reacted badly in the early days of the year as the Fed plans became clearer and more certain.

At Hudson Advisors, we agree with the conclusions of the *Bloomberg* survey. We also have concerns on how the market will react to international tensions and to domestic political news. Overall, we would be pleased to see the major indexes have a 5% to 7% gain in 2022.

OUR STRATEGIES:

Asset Allocation: Most clients should stick to portfolio strategies previously identified. We advise against an increased allocation to equities at this time. We will be assisting some clients to rebalance portfolios where the run-up in equities has thrown off the optimal allocation.

Preferred Equities: As always, despite market conditions, we look for long-term equity opportunities. Our focus is on companies that can weather both the short-term period and flourish in a longer time frame. We want fundamentally sound companies with reasonable valuations and that pay dividends. In that context, similar to last quarter, we are looking at these sectors:

HEALTH CARE: This sector has interesting opportunities in biotechnology and in the variety of new treatments and devices being developed for the aging population.

FINANCIALS: Higher interest rates may benefit the financial sector – and we especially like financial companies with a combination of commercial and investment banking.

INDUSTRIALS/MATERIALS: The legislation to promote infrastructure investments, as it rolls out, should create opportunity for many companies in this sector.

TECHNOLOGY: We are holding but not expanding our allocation to the FANG stocks. We are interested in selective technology companies with emphasis on innovation. These companies can provide "juice" opportunity for a portion of client portfolios.

ENERGY: This sector has opportunities worth exploring in traditional oil and gas industries, in the electric companies that will be modernizing their power grids, and in some of the new alternative energies.

CONSUMER STAPLES: These companies can actually do well in an inflationary environment where consumers watch their spending and stick to basics.

Other Assets: Our aversion to long-term bonds remains and is reinforced by this interest rate outlook. We like maturities under two years and cash and alternative investments such as real estate investment trusts.

Dow Jones U.S. Sectors Total Return
(Percent Change for YTD, Ending December 31, 2021)
Source: Morningstar®

Oil & Gas	**54.44**	**Consumer Services**	**12.01**
Basic Materials	**27.78**	**Telecommunications**	**-8.66**
Industrials	**18.37**	**Utilities**	**17.41**
Consumer Goods	**21.82**	**Financials**	**32.32**
Health Care	**23.62**	**Technology**	**37.23**

William Hudson, Jr., William Hudson, III CFP ®, Jeremy Hudson, & Evan Coppola
4445 North Hwy A-1-A, Suite 233 • Vero Beach, Florida 32963 • (772) 231-8101
237 Main Street, Suite 600 • Buffalo, New York 14203 • (716) 803-6587
David Burrows
29 Hillside Drive • Greenwich, CT 06830 • (203) 302-3530
www.hudsonadvisors.com • **(877) 504-1964**