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Investment Institute


**Weekly perspective on current market sentiment** — **December 22, 2021**

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Last Week's S&P 500 Index: -1.9%

# Conviction needed

## Key takeaways

- The stock market has held up well given investor concerns over higher inflation, the potential pace of Federal Reserve (Fed) tightening, and the spread of the Omicron variant of COVID-19.
- Positive conviction on the likely outcomes of those concerns is needed to have a favorable outlook for equities in the coming year.

Last week we reminded you that transition periods in the economic cycle have often resulted in uncertainty and downside equity volatility. The last handful of trading days has been a perfect illustration of that concept. Stocks initially rallied in the wake of the Fed's latest meeting and then turned around and took it on the chin when growth fears regained some traction as the Omicron COVID-19 variant, which some scientists estimate to be 70 times more transmissible than the Delta mutation, surged across the globe. Investors are seeing some states bring back mask mandates, a number of schools closing, and numerous professional sports leagues (e.g., National Football League and National Hockey League) rescheduling games or even "pausing" the season in response to the virus spreading quickly.

But the overall market has shown a good deal of resilience. We have pointed out many times in the past that on average, over the last 80 years, the S&P 500 Index has had a 10% pullback approximately every 11 months. We came nowhere near that downside level in 2021. It hasn't happened since the early days of the COVID-19 outbreak in March of 2020. For those who watch the charts, we haven't even touched the 200-day moving average since June of last year. That's a long stretch of time. Very unusual.

That comes in the face of a meaningful spike in the Consumer Price Index (CPI) to nearly a 40-year high and a somewhat abrupt shift in the Fed's outlook for monetary policy that implies future rate hikes are closer on the horizon and potentially of a greater magnitude than many market participants anticipated.

So one needs to have some convicted opinions about a few issues to have a favorable view of the coming year along with a plan to potentially take advantage of any downside in the market. First, and possibly most important, investors need to feel comfortable that inflation is going to decelerate as we move through the second half of next year. That is our view. Second, one needs to be comfortable with the thesis that the Fed will move slowly and not make a mistake in 2022. We think the Fed may hike rates twice next year, which would not be a mistake in our opinion. And third, investors need to believe that Omicron, or any other variant of the virus, is not going to lead to widespread shutdowns that would likely create major headwinds for the economy. Based on data we have seen thus far, that appears to be a valid assumption. We also believe the labor market will continue to improve. That's also an important factor to consider.

We believe investors should continue to focus on U.S.-based equity investments; we favor U.S. large-caps and mid-caps. In addition, our favored sectors represent a combination of growth and cyclicals. We like the Information Technology and Communication Services sectors as well as the cyclical Industrials and Financials sectors.

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Each asset class has its own risk and return characteristics. The level of risk associated with a particular investment or asset class generally correlates with the level of return the investment or asset class might achieve. **Stock markets**, especially foreign markets, are volatile. Stock values may fluctuate in response to general economic and market conditions, the prospects of individual companies, and industry sectors. **Mid-cap stocks** are generally more volatile, subject to greater risks and are less liquid than large company stocks. **Sector investing** can be more volatile than investments that are broadly diversified over numerous sectors of the economy and will increase a portfolio's vulnerability to any single economic, political, or regulatory development affecting the sector. This can result in greater price volatility.

**Definitions**

Consumer Price Index (CPI) produces monthly data on changes in the prices paid by urban consumers for a representative basket of goods and services.

S&P 500 Index is a market capitalization-weighted index composed of 500 widely held common stocks that is generally considered representative of the US stock market.

An index is unmanaged and not available for direct investment.

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