ACCESS FINANCIAL SERVICES, INC.

Quarterly Review and Outlook

January 11, 2022

Fourth Quarter, 2021

Table 1: Benchmark Returns as of December 31, 2021

INDEX	3 Mo.	6 Mo.	12 Mo.
US STOCKS			
S&P 500 Index (large-cap stocks)	11.03	11.67	28.71
Dow Jones Select Dividend Index	7.75	6.92	32.24
Russell 2000 Index (small-cap stocks)	2.14	(2.31)	14.82
FOREIGN STOCKS			
MSCI EAFE Net Total Return Index (US$)	2.69	2.24	11.26
S&P Europe 350 Index Net TR Index (US$)	5.82	4.29	16.70
MSCI Japan Net Total Return Index (US$)	(3.96)	0.42	1.71
MSCI Emerging Markets Net TR Index (US$)	(1.31)	(9.30)	(2.54)
COMMODITIES & CURRENCIES			
US Dollar	1.84	3.82	6.71
Euro	(1.81)	(4.12)	(6.93)
Gold	4.11	3.34	(3.64)
Oil (West Texas Intermediate)	0.24	2.37	55.01
MVIS CryptoCompare Bitcoin	4.88	32.23	60.39
BONDS			
BBgBarc US Aggregate Bond (inv. grade)	0.01	0.06	(1.54)
BBgBarc US Treasury 20+ Year	3.52	4.01	(4.37)
BBgBarc US Treas. Inflation Protected Secs.	2.36	4.16	5.96
BbgBarc Municipal Bond	0.72	0.45	1.52
BBgBarc US Corporate TR (corporate bonds)	0.22	0.20	(1.08)
BBgBarc US Corp. High Yield Bond	0.71	1.60	5.28
S&P International Sov Ex-US Bond US$	(1.74)	(3.80)	(9.51)

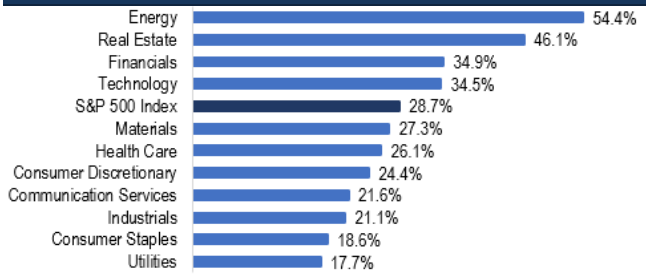
BBgBarc: Bloomberg Barclays; Source: Bloomberg and Morningstar

2021 was a strong year for global risk assets with US large capitalization stocks far outpacing broad based foreign and small capitalization stocks (Table 1). The S&P 500 Index posted 70 all-time highs during the year, the second most record closes ever in a single year. Only 1995, which had 77, was better. Further, the maximum peak to trough move was just -5.2% and the Index never traded below its 200 day moving average during 2021 – a feat that has only happened four other times since 1981.

The year saw all the sectors in the S&P 500 post double digit gains for the first time (Chart 1). While energy and real estate were the biggest gainers, they each only make up about 2.7% of the Index. Financials, which placed third, are about 10.7% of the Index. Technology, the fourth-best performer of 2021, ended 2021 at 29.2% of the S&P 500, by far the largest sector (health care is second at 13.1%). The technology sector now accounts for the highest proportion of the S&P 500 since the dot.com bubble burst in 2000 with technology related stocks Microsoft, Apple, Nvidia, Google and Tesla contributing 349.15 (33.76%) of the S&P 500's 1034.14 total point gain for 2021. These five stocks now make up 20.7% of the Index.

Generous fiscal stimulus, expansionary monetary policy and an early start to the Covid immunization campaign provided significant tailwinds for the economy and financial markets during the year. The recovery should continue this year despite Omicron, with US gross domestic product (GDP) generally expected to revert to its pre-Covid path by year end. This is true for most other developed economies globally as well.

Chart 1: 2021 S&P 500 Sector Total Returns



Source: Access Financial Services using Bloomberg Data

Emerging markets (EMs), on the other hand, are slowing due to China's housing crisis, monetary policy tightening in Latin America and high infection rates as vaccines are less available in EMs. China's slowdown represents one of the main risks to the global outlook, both due to its size and because weaker Chinese growth curbs export revenues and investment in resource rich countries. Reduced credit to developers and homebuyers, Beijing's 'zero Covid' policy and declining infrastructure spending all reduce the likelihood that China grows above potential this year. Besides weaker Chinese growth, fiscal consolidation and rapid monetary tightening in most major EMs further weakens EM growth prospects.

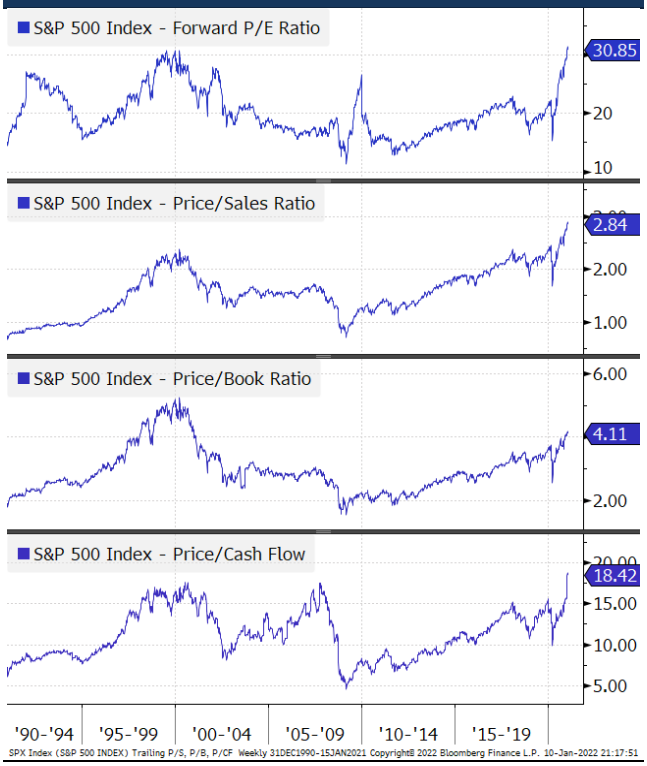
Arguably, two of the most important macro factors for financial markets this year are inflation and employment. More specifically, their impact on monetary policy and interest rates. In an environment where financial assets are richly valued (Chart 2) as a result of the massive fiscal stimulus and central bank liquidity injections since February 2020 (Chart 3), along with ultra-low interest rates, risk assets have a history of stumbling when liquidity is withdrawn and interest rates rise.

The combination of supply disruptions, soaring energy prices, strong goods demand, and generous policy stimulus pushed inflation well above market expectations in 2021.

Consumer Price Index inflation in the US is running at 6.8% year-over-year (Chart 4), its highest level since the early 1990s and four standard deviations above its ten year average level. Much of the increase stems from goods producing sectors which are facing soaring logistics costs and extended delays in delivery times. Extraordinary fiscal

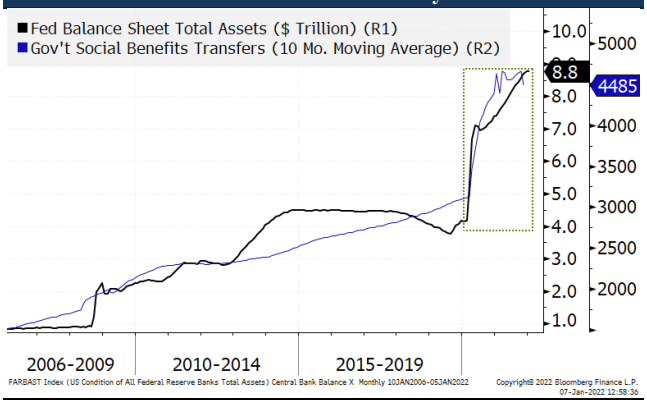
stimulus and tight labor supply has amplified supply and demand imbalances.

Chart 2: Stock Market Valuations



Source: Access Financial Services using Bloomberg Software & Data

Chart 3: Massive Stimulus Since February 2020



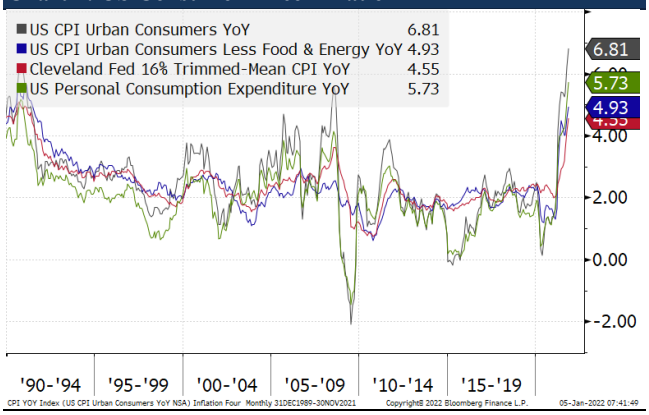
Source: Access Financial Services using Bloomberg Software & Data

Producer price indices (PPIs), which measure price change from the perspective of the seller, are even more elevated than consumer prices (Chart 5). The latest year-over-year PPI of 13.35% is the highest since August 1980 and PPI relative to its five year average is the highest since 2008.

Very recently however, companies seem to have either gotten a handle on their supply chain issues, or have built up sufficient stores to meet demand, according to two recent data sets. That suggests some easing of inflationary pressure in the months ahead.

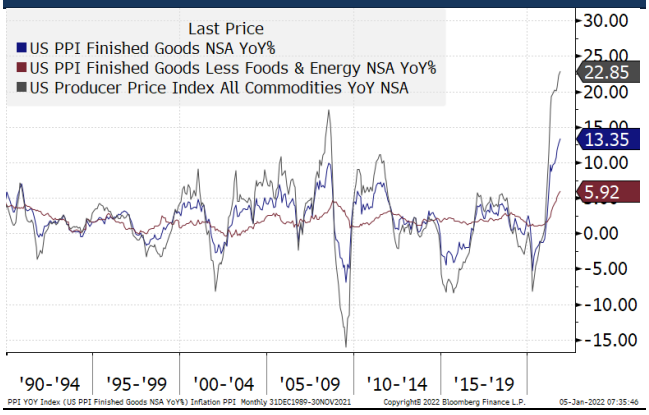
January 5 data from the Institute of Supply Management shows factories were better-positioned to meet December's strong demand. There were positive signs for logistics performance and there were less price pressures. The delivery delays index posted the lowest reading since November 2020, down 7.3 points to 64.9. Additionally, the price index dropped to November 2020 levels (Chart 6).

Chart 4: US Consumer Price Inflation



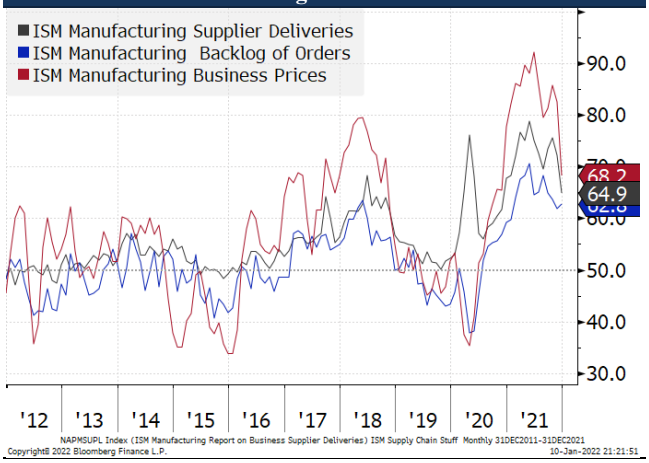
Source: Access Financial Services using Bloomberg Software & Data

Chart 5: US Producer Price Inflation



Source: Access Financial Services using Bloomberg Software & Data

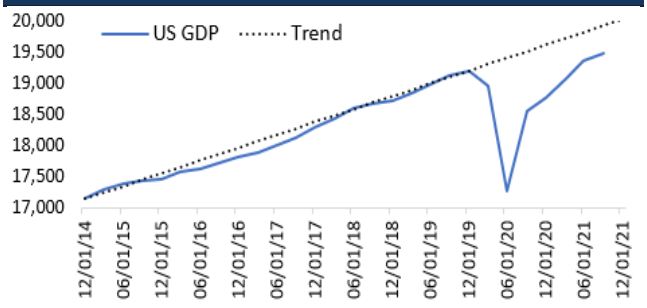
Chart 6: ISM Manufacturing Indices



Source: Access Financial Services using Bloomberg Software & Data

While economic activity in the US has rebounded sharply since bottoming in the second quarter of 2020, growth as measured by GDP is still about $445B (2.2%) below its pre-pandemic path (Chart 7).

Chart 7: US Gross Domestic Product



Source: Access Financial Services using Bloomberg Data

Chart 8 breaks down output gains and losses from Covid by component of GDP. Some segments, like spending on consumer goods and investment clearly benefited from reduced mobility. The remaining losses reflect low demand for services, weak exports and depleted inventories.

Chart 8: US Output Excess/Shortfall by Category

Output excess/shortfall is 3Q21 GDP vs. it's pre-pandemic path by category
Source: Numera Analytics

Assuming vaccines remain effective against severe infection and states do not reinstate stay at home orders, we should expect a higher share of budgets to be allocated from goods to services. Substitution away from goods, combined with reshoring of manufacturing and improvements in infrastructure should allow manufacturers to rebuild inventories and increase export volumes. The more persistent the Omicron impact, the longer it will take for these expenditure shifts to unfold though.

Some are claiming the strong economic growth in recent quarters represent overheating demand. It is more likely this strong growth is just the natural snapback after the pandemic induced collapse in early-2020. The implication is that the strong recent growth is unsustainable, just as the bounce that a ball experiences after a big drop is unsustainable. Indeed, while fourth quarter 2021 annualized GDP forecasts are in the 6% neighborhood, the forecasts decline over the next six quarters back to their longer term average of 2.5% (Table 2).

Table 2: US Real GDP – Quarterly Change % Annualized

Actual								Forecasts						
4Q 19	1Q 20	2Q 20	3Q 20	4Q 20	1Q 21	2Q 21	3Q 21	4Q 21	1Q 22	2Q 22	3Q 22	4Q 22	1Q 23	2Q 23
1.9	-5.1	-31.2	33.8	4.5	6.3	6.7	2.3	6.0	4.0	3.6	3.1	2.6	2.5	2.4

Source: Access Financial Services using Bloomberg Data

So, if overall growth still lags its pre-pandemic trend, why is inflation so high? The answer is that inflation has been fueled by the displacement of demand into goods from services.

If a dollar spent on goods is displaced from a dollar spent on services, then overall demand will be unchanged. However, what happens to overall price levels depends on the relative price elasticities of demand for goods and services. If the price elasticities are the same, then overall prices will also be unchanged, but if the price elasticities are different, then overall prices can rise even if the dollars spent are relatively unchanged.

As it stands, spending that requires close contact with strangers – mostly services – is suffering significant shortfalls compared to pre-pandemic times while spending on goods has accelerated which has resulted in demand outpacing supply and sharply higher prices for a number of goods.

It follows that if the spending on goods cools, then inflation will also cool. It makes sense that this 'good' resolution of inflation will unfold because there are only so many goods that any person can buy. Durable goods, by their very definition, last a long time. Even clothes and shoes, though classified as nondurables, are actually pretty durable. There are only so many cars, iPhones, gadgets, clothes and shoes a person can own before reaching saturation.

That said, the resolution of inflation could also take a 'bad' form. If inflation persists, then interest rates are likely to rise to the point where growth is choked off. Given that long duration bonds set the valuations of long duration stocks[1], and given that stock valuations are already stretched, this would pressure risk assets.

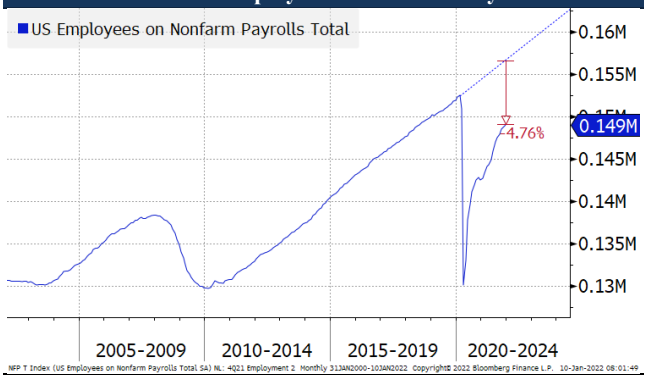
More significantly, it would also inflict pain on the all-important real estate market. Over the past ten years, world prime residential prices are up 70% while rents are up by just 25%[2]. The takeaway is that the bulk of the increase in global real estate prices is due to skyrocketing valuations on the back of the collapse in global interest rates and the implication is that bond yields have a limited scope to rise before adversely impacting the $300 trillion global real estate market. Given the size of the market dwarfs the $90 trillion global economy, the deflationary backlash would overwhelm any lingering inflation.

[1] Stocks are said to be long duration assets because their value is dependent on cash flows far into the future.

[2] Based on Savills Prime Index: World Cities – Capital Values, and World Cities – Rents and Yields, June 2011 through June 2021.

The job market is echoing the uneven recovery in economic activity. As was the case in 2002 and 2010, job creation has lagged the broad economic recovery. Nonfarm payrolls are still 2.6% (4 million jobs) below their pre-Covid peak and about 4.75% below their pre-Covid path (Chart 9), versus GDP which is lagging by 2.2%. This recovery path reflects structural factors like firm restructuring, small and medium size business closures and the increased dominance of capital intensive sectors and away from service sectors.

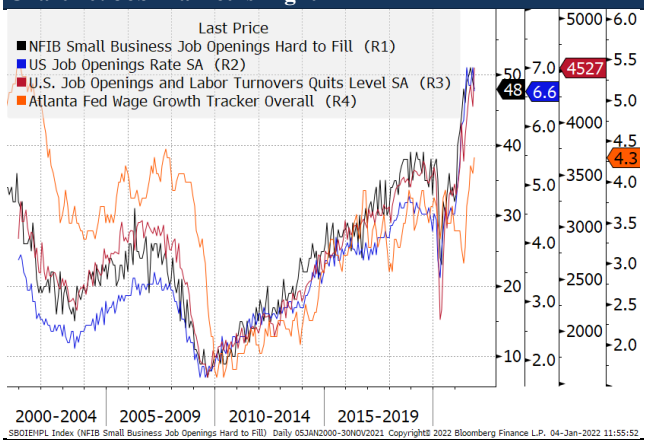
Chart 9: Number of Employees on Business Payrolls



Source: Access Financial Services using Bloomberg Software & Data

Despite lower employment levels, many indicators point to a very tight job market (Chart 10). In particular, the ratio of openings per unemployed worker has risen to an all-time high of 1.5 vacancies per job seeker. Given still low employment levels, tight job market conditions reflect low labor supply as millions of workers have opted for early retirement, or expect a higher salary and/or different working conditions to reenter the job market.

Chart 10: Job Market is Tight



Source: Access Financial Services using Bloomberg Software & Data

A high vacancy-to-unemployment ratio often translates into faster wage growth as firms compete for a limited pool of workers. Hourly wage growth is likely to exceed 5% in 2022, compared to 4% in 2021. This would amount to the strongest full year increase in nominal wages over the past four decades.

Throughout 2021, the Fed's view was that the rising inflation we were experiencing was likely to be a transitory phenomenon. Then, in December, the Fed made a hawkish pivot by dropping the term 'transitory' when discussing inflation.

During periods of low and stable inflation, the Fed can engage in relatively measured monetary policy tightening with the assumption that strong economic growth can withstand the normalization of interest rate policy. In other words, they can hike rates because they *want* to. Inflation, on the other hand, can force central banks to act more aggressively than they might otherwise want to leading them to tighten because they *have* to. The latter case implies less sensitivity to financial market reactions than the former.

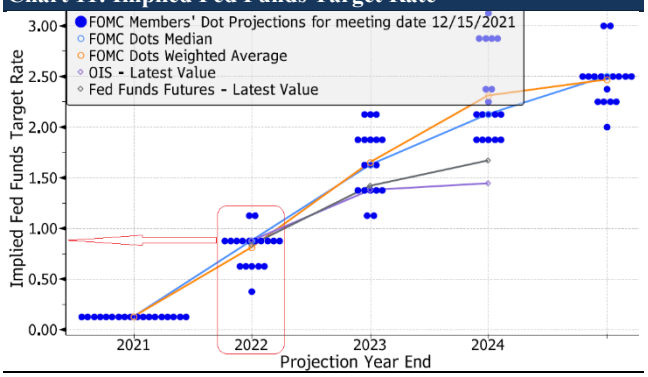
Anyone who started investing after the peak of the dot-com bubble will be unfamiliar with this scenario. Starting in 2001, every easing cycle has featured a rate move of at least 0.50% in one shot, while each tightening cycle has been conducted in 0.25%, forward-guided (telegraphed) increments. Furthermore, the magnitude of each easing cycle in this century has exceeded that of the subsequent tightening. The reality is that it has been two decades since the Fed has been properly hawkish.

Given high inflation and a tight job market, the Fed committed to reducing monthly asset purchases (quantitative easing) at twice the pace initially planned, and a quicker timeline for interest rate increases in minutes from its December 15 meeting which were released on January 5. Fed officials now see lifting short term interest rates in three quarter-point increments during 2022 (Chart 11) while the financial markets are looking for four hikes this year according to the Fed Funds futures market (Chart 12). As recently as late September 2021 the Federal Funds futures market was priced for zero rate hikes over the next twelve months. While this newly hawkish dialogue is causing a bit of a stir in the financial markets, we need to remember that the benchmark rate would still be below 1% nominally and negative on a real (inflation adjusted) basis by year end if the Fed's projections turn out to be accurate.

The case for higher short term interest rates was strengthened by the January 7 employment report which showed unemployment dropped and wages rose by a faster than expected pace. In fact, it can be argued that the economy is now operating at full employment which has been achieved far more quickly than we projected back in July (Chart 13).

Yet Fed officials remain surprisingly dovish over the longer term according to their projections released following the December meeting. Their median forecast has inflation falling to 2.6% this year, 2.3% in 2023 and 2.1% in 2024. This would make sense if they expected to aggressively tighten monetary policy, but that doesn't seem to be the case – at least not yet.

Chart 11: Implied Fed Funds Target Rate

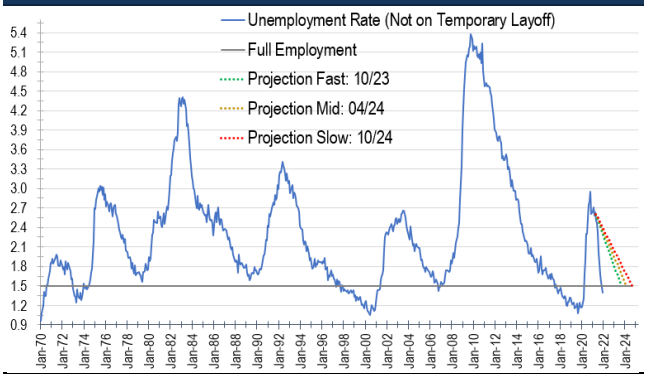


Source: Access Financial Services using Bloomberg Software & Data

Chart 12: Fed Funds Futures

Source: Access Financial Services using Bloomberg Software & Data

Chart 13: Unemployment Rate for Those Not Temporarily Laid Off Since 1970

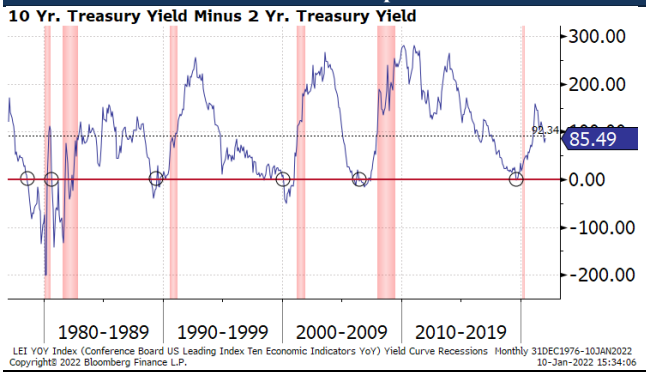


Source: Access Financial Services using Bloomberg Data

In 2022, the financial markets will be heavily dependent on the Fed's ability to tame inflation without damaging the economy. One measure of success is when the Fed is able to tighten monetary policy without causing a recession. Each time we have had a recession in the last 40 years, it has been preceded by a Fed rate hike campaign that led to an inversion of the Treasury yield curve (long term interest rates lower than short term interest rates) (Chart 14).

At its current level of +0.86%, the '2s 10s' yield curve is right around its average level of +0.92% since 1976 and not at risk of inverting, and the probability of recession is only 15% according to the most recent survey of economists by Bloomberg.

Chart 14: Yield Curve – 2/10 Yield Spread



Red shading on chart indicates recessions.
Source: Access Financial Services using Bloomberg Software & Data

After almost two years of reflationary fiscal and monetary policy aimed at a recovery of the economy, financial markets and employment, we now find ourselves in an environment of high inflation, solid economic growth and closing in on full employment – a scenario often referred to as 'overheating' in which persistently high inflation coincides with an economy operating above full employment. Overheating is typically associated with below average financial market returns (Table 3) because it stokes fears of aggressive monetary policy resulting in reduced stock market valuations and bond prices.

Table 3: Average Real Yearly Returns by Regime Since 1967

	Overall Avg.	Recession	Recovery	Reflation	Overheating	Stagflation
S&P 500 Index	7.6%	3.0%	15.0%	8.4%	5.8%	-4.8%
BofAML Bond Index	3.4%	8.9%	5.4%	1.4%	-0.5%	-1.3%

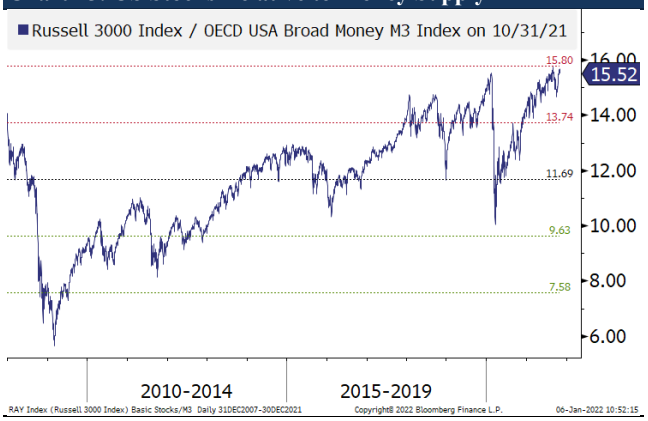
Source: Numera Analytics

As further evidence of the US stock market's liquidity driven high valuation, Chart 15 tracks the ratio of stock prices (Russell 3000 Index) to US broad money (M3). Unlike alternative valuation metrics, this ratio captures the extent to which stocks absorb and benefit from the liquidity provided by monetary and fiscal stimulus. Today, the long run ratio of stock price to broad money is well above its normal range, suggesting that equity markets have maxed out stimulus gains. This reduces the magnitude of future returns versus earlier in the pandemic as the liquidity environment is moving from being a tailwind to a headwind.

With the rollback in government spending programs put in place at the height of the pandemic, the Fed's ending its quantitative easing (emergency bond buying program) and beginning its quantitative tightening program while lifting short term interest rates, 2022 will see the economy and financial markets learning to live without the stimulus that has unquestionably driven the strong gains in risk assets since the beginning of the pandemic.

In addition to stimulus being withdrawn, corporate profitability is expected to trend lower next year with S&P 500 earnings growth expected to slow to less than 9% in 2022 from 47% in 2021.

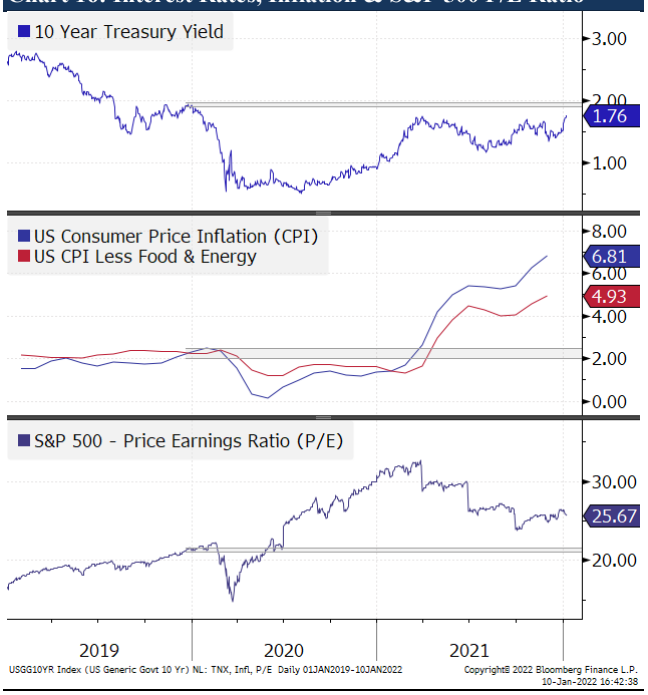
Chart 15: US Stocks Relative to Money Supply



Source: Access Financial Services using Bloomberg Software & Data

The financial markets are in the process of what appears to be the repricing of this new environment. Between December 17 and January 10, the ten year Treasury yield has risen from 1.34% to 1.79%, the highest since January 2020 and closing in on levels seen just prior to the pandemic when inflation was a bit above 2% and the price/earnings ratio of the S&P 500 was 21 (Chart 16). While a sub-2% yield is far from being high, the move puts the yield 34% higher in less than a month and is pressuring financial assets to the downside – especially those with the highest valuations.

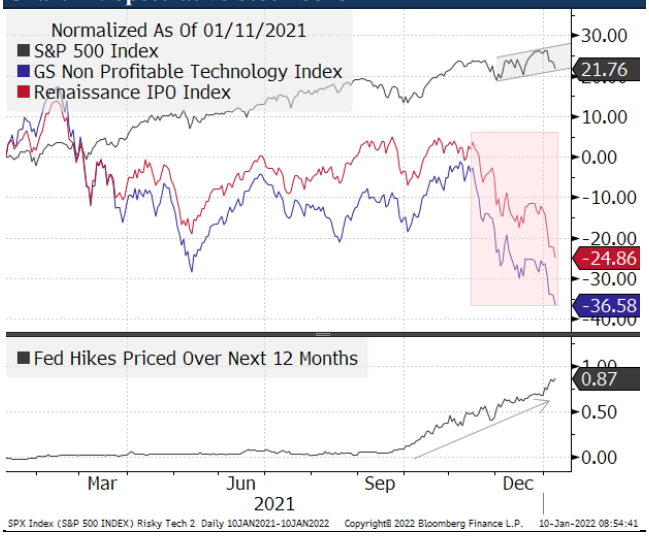
Chart 16: Interest Rates, Inflation & S&P 500 P/E Ratio



Source: Access Financial Services using Bloomberg Software & Data

The tone of the market actually began changing in mid-November as expected changes in short term interest rates began gaining momentum with declines in the most speculative areas of the market such as profitless technology companies (down 36% since November 8) and initial public offerings (down 26% since November 8) (Chart 17). Cryptocurrencies (as measured by the Bloomberg Galaxy Crypto Index) also peaked around the same time (November 9) are now down 41%.

Chart 17: Speculative Stock Selloff



Source: Access Financial Services using Bloomberg Software & Data

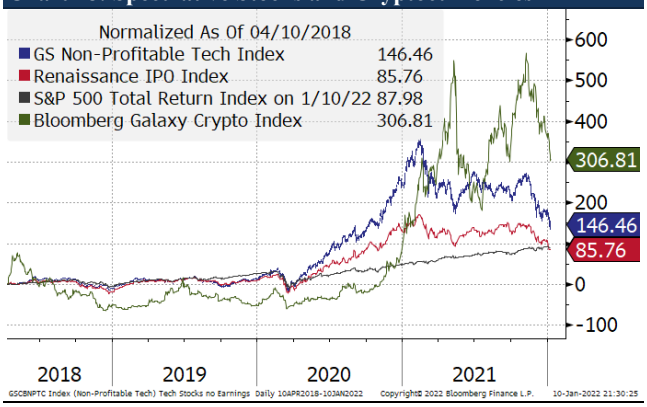
During the pandemic when stimulus was in full force, investors didn't seem concerned about current profitability when investing in stocks. It was outsized expected *future* profits that mattered and it is these field-of-dreams stocks that rely most heavily on ultra-low discount rates (interest rates) to justify the endless rise in their prices ($1 of expected earnings ten years in the future is worth $1 today if discounted at an annual rate of 0%, right? …Wrong.).

To be sure, the outsized gains in the most speculative corners of the financial markets were bound to deflate as dramatically as they advanced and there is probably some distance to go before the process is complete (Chart 18). The real issue is that many companies with actual earnings are also trading at high valuations – particularly technology related shares. These stocks are also relying on low interest rates and high earnings growth to justify their elevated prices and valuations. As bond yields/interest rates in the US have risen, these companies' stock prices are also coming under pressure. The NASDAQ Composite Index, which consists mostly of technology related companies and the S&P 500 technology sector are down 7.4% and 7.8%, respectively, since January 3. As an aside, earnings growth for the S&P 500 technology sector is expected to decline from 42% in 2021 to just 6% in 2022. This is 3% less that the overall S&P 500.

In addition to rising interest rates pressuring stock valuations (Chart 19 – interest rates shown inverted), high inflation rates are normally associated with lower stock

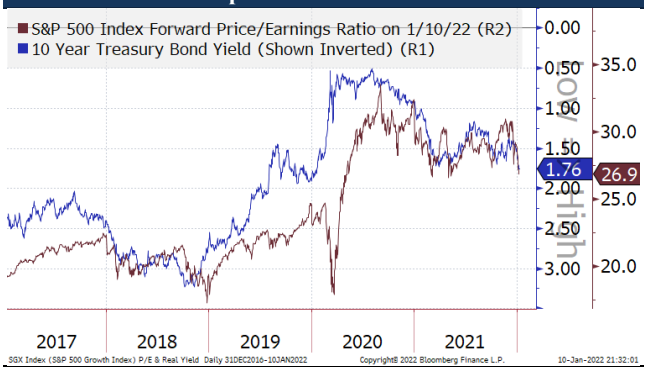
market valuations (Chart 20). Today's core CPI level of 4.9% has historically been associated with a price/earnings ratio significantly lower than the current reading of 25.3.

Chart 18: Speculative Stocks and Cryptocurrencies



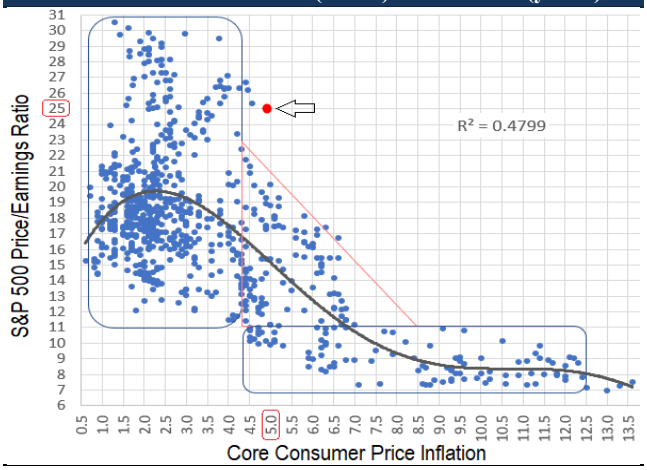
Source: Access Financial Services using Bloomberg Software & Data

Chart 19: Relationship Between Valuations and Bond Yields



Source: Access Financial Services using Bloomberg Software & Data

Chart 20: S&P 500 P/E Ratio (x-axis) & Core CPI (y-axis)

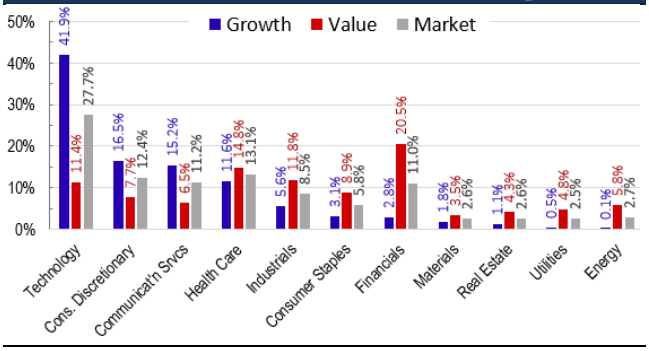


Note: red marker is most recent observation.
Source: Access Financial Services using Bloomberg Data

Ultimately, the scope for higher interest rates is limited by the fragility of the financial and real estate markets. Unfortunately, it is impossible to know where the breaking point is. Wherever it is, if we reach it, longer term interest rates will reverse course as the quest for safety drives bond prices up causing the yield curve to flatten – or possibly invert. We don't expect this to happen soon.

In our second quarter, 2021 *Review and Outlook*, we noted that it is common to separate stocks into two categories: growth and value. S&P Dow Jones Indices categorizes value stocks as those stocks having low price/book value ratios, low price/earnings ratios, and low price/sales ratios. Growth stocks have high levels of sales growth, earnings growth, and stock price momentum. The market weighting of the stocks in each category is shown in Chart 21.

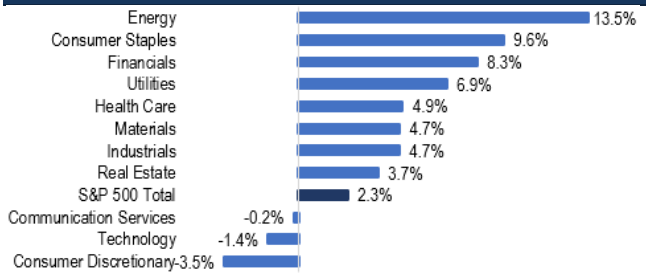
Chart 21: S&P 500 Growth and Value Sector Composition



Source: Access Financial Services using BlackRock Data

Since the market bottomed on March 23, 2020, the S&P 500 Growth Index has outperformed the S&P 500 Value Index by 25%. Recently, however, the value index has outpaced its growth counterpart by almost 10% since December 1 as investors have rotated out of more richly valued technology related stocks into more defensive stocks that tend to outperform when inflation and interest rates are rising and stocks in general are struggling (Chart 22).

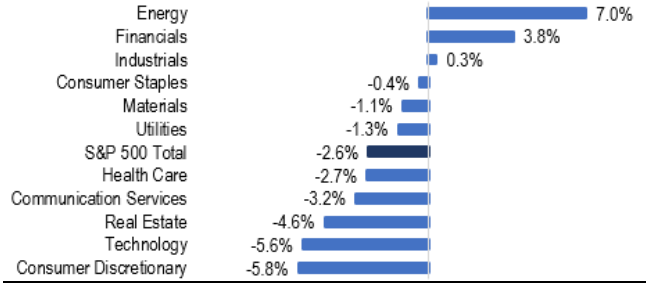
Chart 22: S&P 500 Sector Total Returns Since December 1



Source: Access Financial Services using Bloomberg Data

This trend has persisted since the S&P 500's all-time high on January 3 (Chart 23).

Chart 23: S&P 500 Sector Total Returns Since January 3

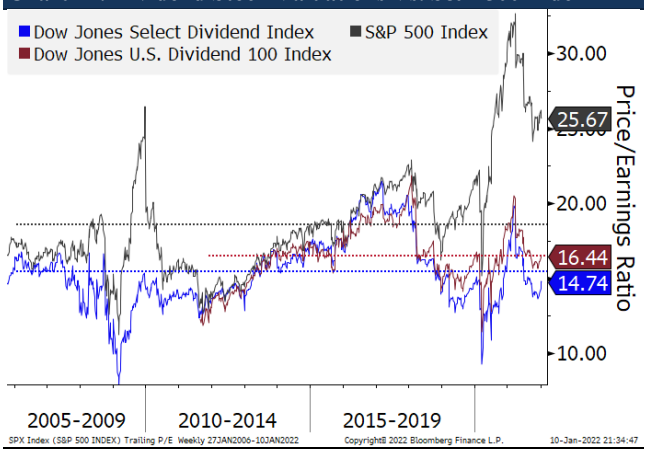


Source: Access Financial Services using Bloomberg Data as of Jan. 10, 2022

As it stands, our clients' portfolios are underweight stocks in general and underweight technology, communication services and consumer discretionary stocks relative to the S&P 500. We are overweight energy and financial stocks.

We are also overweight dividend paying stocks in general because this group has more attractive valuations that are at or below their long term averages (Chart 24) and because dividends become an increasingly important component of total return when stock price appreciation stalls.

Chart 24: Dividend Stock Valuations Vs. S&P 500 Index



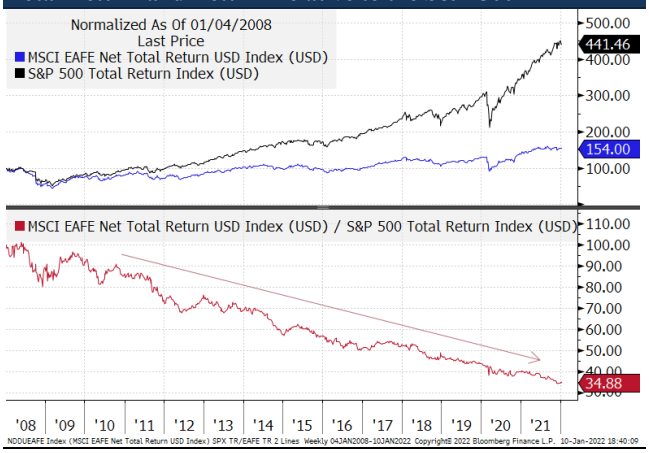
Note: dotted lines are long term average price/earnings ratios
Source: Access Financial Services using Bloomberg Software & Data

We have limited exposure to small company and foreign stocks – both of which have underperformed US large company stocks recently and over the last decade (Chart 25 and 26). We are watching these two groups closely though because this environment tends to be supportive to both groups relative to US large company stocks.

For now, deeper stock pullbacks and more modest returns are the most likely scenario in 2022 after abnormally smooth sailing in financial markets over the last 18+ months (Chart 27). Another stock market rally in 2022 would make for a four year winning streak which has happened only five times in nearly a century.

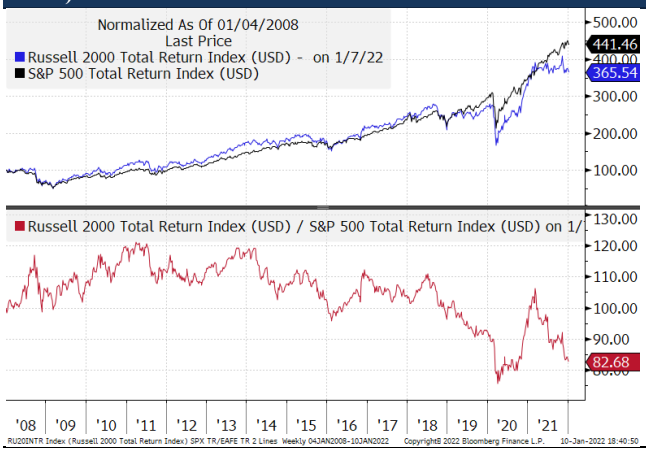
We remain in the game but are positioned conservatively.

Chart 25: Foreign Stock Performance (MSCI EAFE Index) – Total Return and Return Relative to the S&P 500



Source: Access Financial Services using Bloomberg Software & Data

Chart 26: Small Company Stock Performance (Russell 2000 Index) – Total Return and Return Relative to the S&P 500



Source: Access Financial Services using Bloomberg Software & Data

Chart 27: S&P 500

Source: Access Financial Services using Bloomberg Software & Data

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